# Petition

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in the

# Supreme Court

of the

# United States

October Term, 1981

THOMAS R. PLEDGER AND PHYLLIS R. PLEDGER,
*Petitioners,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

## PETITION

Rogers and Meisel
400 Royal Palm Way
Palm Beach, Florida 33480

THOMAS R. PLEDGER AND PHYLLIS R. PLEDGER,
*Petitioners*

*vs.*

COMMISSIONER OF INTERNAL REVENUE

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## PETITION FOR WRIT OF CERTIORARI FROM THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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To the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your Petitioners, Thomas R. Pledger and Phyllis R. Pledger, hereby petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Fifth Circuit holding that it is constitutionally permissible to measure income received in property by something other than the exchangeable value of the property actually received.

## QUESTIONS PRESENTED FOR REVIEW

1. Can an amount in excess of the fair market or exchangeable value of property received as compensation be classified as current income for purposes of taxation?

2. Does a statute imposing a tax on an amount in excess of the fair market or exchangeable value of property received as compensation violate the due process clause of the Fifth Amendment of the United States Constitution?

## LIST OF ALL PARTIES

**The caption in this case contains the names of all parties.**

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## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at 641 F.2d 287, and the opinion of the United States Tax Court is reported at 71 TC 618. These are appended hereto as appendices A and B, respectively.

## GROUNDS FOR JURISDICTION

The decision sought to be reviewed in this case was entered by the United States Court of Appeals for the Fifth Circuit on April 2, 1981. A timely motion for rehearing was filed on April 16, 1981 and denied by order entered on April 29, 1981. A copy of the order denying rehearing is included as Appendix C. The statutory provision conferring jurisdiction on this Court to review the judgment and court decree in question is 28 U.S.C. §1254(1).

## CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

The Fifth and Sixteenth Amendments to the Constitution of the United States of America and Section 83(a) of the Internal Revenue Code of 1954 as set forth in Appendix D to the Petition.

## STATEMENT OF THE CASE

During the year 1971, Thomas R. Pledger, herein referred to individually as Petitioner, purchased 30,000 shares of common stock of Burnup & Sims, Inc. by exercising an option given to him as compensation. The exercise of the option was a taxable event giving rise to compensation income. The issue in this case involves the proper measure of that income.

More specifically, the stock acquired by Petitioner was issued under the private placement exceptions to the registration requirements of the Securities Act of 1933. Such stock is referred to as "lettered" and as a matter of law, could not be sold publicly for a period of at least two years from the date of acquisition. It was only possible to sell such stock in another private placement. Because of this restriction, the parties to this proceeding stipulated that if such stock had been sold on the date of acquisition, the price would have been subject to a discount of 35% from the fair market value of its registered counterparts.

Section 83 of the Internal Revenue Code of 1954 provides that the value of compensation in the form of stock for purposes of income taxation is to be determined by reference to the fair market value "***(determined without regard to any restriction***)". Under that Section, the value of the compensation received by Petitioner in stock is determined by reference to the fair market, or exchangeable value of its registered counterparts and not by reference to the fair market, or exchangeable value of the stock actually received. The issue in this case is whether it is constitutionally permissible to tax

the excess of the value of registered shares over the value of the shares actually received as income.

It is Petitioner's position that the term "income" as used in the amendment to the Constitution means something of exchangeable value; that Congress can not alter the Constitution by changing the definition of that term as used in the amendment; and that, Section 83 effectively alters the Constitution by defining income as including something in excess of value actually received. Accordingly, such Section is contrary to the Constitution.

A divided Court of Appeals concluded that income can be legislatively defined as something other than the exchangeable value of property received as compensation. On the basis of this conclusion, it held that the statute defining income as the value of property, determined without regard to restrictions on that property, was constitutionally valid. There was a dissent with respect to this rationale.

Petitioner also takes the position that a tax on the excess amount violates the due process clause since it imposes a tax on something that does not exist. The Court of Appeals rejected this position largely on the basis of a rationale that there was a temporary dimunition in value as opposed to a nonexistent value. This was necessarily predicated upon a conclusive presumption that the taxpayer would have property with an exchangeable value equal to the value of the registered counterpart when the restriction lapsed. It is Petitioner's position that such a conclusive presumption of fact violates the Constitution.

## BASIS FOR FEDERAL JURISDICTION IN THE COURT OF FIRST INSTANCE

This proceeding was initiated by a Petition to the United States Tax Court seeking a redetermination of a deficiency in income tax as determined by the Commissioner of Internal Revenue. The Tax Court had jurisdiction under 26 U.S.C. §6214, and the Court of Appeals had jurisdiction to review the decision of the Tax Court under 26 U.S.C. §7482.

## ARGUMENT AMPLIFYING THE REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

It is submitted that the writ should be allowed because the Court of Appeals decided an important question of Federal law in a way that is in conflict with the applicable decisions of this Court. More specifically, the Court of Appeals held that Congress could define the term "income" in a manner that conflicts with this Court's definition of that term as set out in *Eisner v. Macomber*, 252 U.S. 189 (1920). In addition, in order to sustain the validity of the statute in question, the Court of Appeals necessarily held that a temporary dimunition in value caused by a restriction would be realized at sometime in the future. Such is tantamount to upholding a conclusive presumption of fact which is in conflict with the decision of this Court in *Heiner v. Donnan*, 285 U.S. 312 (1932). Each of these is treated separately in this Petition.

1. **Congress can not constitutionally define income as including an amount that is not income as that term is defined in the amendment to the Constitution.**

The question involved in this case is identical with the question involved in *Eisner v. Macomber, supra.* The statute in this case defines income as the fair market value of property received as compensation determined without regard to any restriction. The statute in *Eisner* defined income as including stock dividends to the amount of its cash value. Both statutes imposed a tax on the income so defined.

In *Eisner*, this Court held that it was essential to distinguish between what is and what is not income as that term is used in the amendment to the Constitution. It then stated that:

> "Congress can not by any definition it may adopt conclude the matter, since it can not by legislation alter the Constitution, from which alone it derives its power to legislate***"

In effect, Congress can not create income by definition where income does not exist. This Court then proceeded to define income as:

> "***a gain, a profit, something of exchangeable value***received or drawn by the recipient*** for his separate use***. Nothing else answers the description."

The definition is clear and unequivocal. There is no income unless a taxpayer receives something of exchangeable value.

As herein pertinent, Section 83 is an attempt to create income where it does not exist by definition, i.e. by defining income as the value determined without

regard to any restriction, where a restriction does, in fact, exist. Indeed, the Court of Appeals specifically recognized this by holding that Congress may establish (define) value as taxable value that "***is not the value the taxpayer can receive upon immediate sale." Clearly, the taxpayer did not receive exchangeable value. Accordingly, he did not receive income and no congressional definition can change that fact. The holding of the Court of Appeals is obviously in conflict with the decision of this Court in *Eisner* and the well accepted rule that income is measured by the value of what is received.

The Court of Appeals stated that the *Eisner* rule was stating what was income, not defining the amount of income received. This position was amplified in footnote 10 where the Court stated that something of exchangeable value was received, but that its income tax value could not be determined by its immediate exchangeable value. In effect, a taxpayer realizes taxable income when he realizes exchangeable value but such exchangeable value does not determine the amount of that income. This is obviously a tortured attempt to justify that which can not be justified. If income is exchangeable value, the amount of that income is also exchangeable value.

The Court of Appeals cited *Commissioner v. Glenshaw Glass Company*, 348 U.S. 426 (1955) as support for its proposition that the *Eisner* definition of income had been changed. *Glenshaw* provides absolutely no support for such a proposition. In the cited case, the issue was whether cash actually received as punitive damages was taxable income. Such cash constituted, in the language of the *Glenshaw* opinion "***undeniable

accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.". Indeed, the cited case specifically distinguished *Eisner v. Macomber* by noting that the taxpayer there had received nothing whereas the *Glenshaw* taxpayer had. Obviously, this is a restatement of the "exchangeable value" standard. It is certainly not a limitation thereon. Clearly, a decision holding that cash is taxable income can not be cited as support for the proposition that income can be measured by something other than exchangeable value.

2. **The definition of income contained in Section 83 results in a tax based on a conclusive presumption of a fact which violates substantive due process.**

As is shown by the facts in this case, Section 83 imposes a tax on a value which does not currently exist. The only conceivable justification for such taxation is that the full value of the property will exist at the time the restriction lapses, i.e. in the words of the Court of Appeals, taxing the full value is justified because the restriction results only in a temporary dimunition of that value. Reduced to essentials, this is nothing more than a conclusive presumption that the property will have the full value when the restriction lapses. If such is the rationale, the statute must fail since it imposes a tax on a presumption of fact the taxpayer can not controvert.

This is in accord with the rule established by *Heiner v. Donnan*, 285 U.S. 312 (1932) and *Schlesinger v. Wisconsin*, 270 U.S. 230 (1926). In both cases, the Supreme Court struck down statutes conclusively presuming that certain gifts were made in contemplation of death. In effect,

the Court noted that whether a transfer was in contemplation of death was a question of fact, and concluded that "***a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert is so arbitrary and unreasonable that it can not stand***".

The ills of a conclusive presumption of fact are readily apparent from the facts of this case. Here the conclusive presumption is that the stock received as compensation has the same value as its registered counterpart whereas, in fact, its actual value is only 65% of that value. In short, the tax is predicated upon a fiction and is, therefore, contrary to due process. *Hoeper v. Tax Commissioner*, 284 U.S. 206 (1931).

The Court of Appeals effectively held that the irrebuttable presumption doctrine in the cited cases was no longer applicable in "purely economic matters". In support of this position, it cited *Weinberger v. Salfi*, 422 U.S. 749 (1975) and *Usery v. Turner Elkhorn Mining Company*, 428 U.S. 1 (1976). Neither of those cases supports the proposition that this Court has abandoned the irrebuttable presumption doctrine.

*Weinberger v. Salfi* involved the denial of benefits under Social Security to a widow who was married within nine months of death on the basis of a conclusive presumption in the Social Security laws. In upholding the statute and the conclusive presumption, the Supreme Court clearly stated that its conclusion was based on the fact that a noncontractual right to receive benefits from a government enjoys no constitutionally protected status. This is nothing more than a restatement of the

rule that Congress has the right to create classifications that allocate noncontractual benefits under a social welfare program. See *Califano v. Goldfarb*, 430 U.S. 199 (1977). It does not change the rule where an individual does enjoy a constitutionally protected status to retain his own property.

*Turner Elkhorn* is even less on point. That case involved irrebuttable presumptions that miners who are clinicly demonstrated as being afflicted with complicated pneumoconiosis are totally disabled, and if they die, such death was attributable to such disease. The Supreme Court did not hold that the irrebuttable presumption doctrine was dead. What it did was to note that Congress could compensate directly for the disease; and that there was no irrebuttable presumption that an individual was so afflicted. On this basis, it concluded that the choice of language, *i.e.* calling the benefit "total disability" as opposed to "direct compensation", can not invalidate a statute "***when its operation and effect are clearly permissible." In short, there was a factual issue and not an irrebuttable presumption as to whether an individual was afflicted with the disease. If he was, Congress could approve compensation and thus there was no irrebuttable presumption of a necessary fact.

In summary, a review of the cases establishes that the irrebuttable presumption doctrine is still the law. It is not however, applicable where the issue relates to the person's rights to receive noncontractual benefits from a government. The instant case does not fall within that excepted category. To the contrary, it is a case where the government is depriving an individual of his property through taxation based on a fiction.

## CONCLUSION

Petition for Writ of Certiorari should be granted.

Respectfully submitted

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July 1981

# Appendix A

71 T.C. No. 58

UNITED STATES TAX COURT

THOMAS R. PLEDGER AND PHYLLIS R. PLEDGER,
*Petitioners*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent*

FAUSTO A. FUENTES AND MARY JANE FUENTES,
*Petitioners*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent*

Filed January 23, 1979.

Docket Nos. 10855-75,
6532-76,
6533-76,
6557-76.

[SERVED JAN 23 1979]

Petitioner Pledger acquired 30,000 shares of stock in 1971 pursuant to the exercise of a nonstatutory employment stock option governed by sec. 83, I.R.C. 1954. The stock was not subject to a substantial risk of forfeiture or a restriction which by its terms would never lapse. However, the stock was subject to restrictions imposed by Federal securities law. These restrictions would have reduced the value of the stock by 35 percent had Petitioner Pledger sold the stock immediately following acquisition. *Held*, restrictions imposed by law, i.e., Federal securities law, are within the meaning of sec. 83(a)(1), and the measure of compensation is determined by the difference between the amount paid for the stock and the fair market value of the stock on the date of acquisition, determined without regard to the restrictions imposed by law under the facts of the instant case. *Held further*, sec. 83 is not unconstitutional under the 5th or 16th Amendment to the Constitution of the United States. *Sakol v. Commissioner*, 67 T.C. 986 (1977), affd. 574 F.2d 694 (2d Cir. 1978), cert. denied 439 U.S. ____ (1978).

Petitioner Fuentes, a United States citizen at all times pertinent, was granted an employee stock option in 1968 while a bona fide resident of Puerto Rico for services performed and to be performed in Puerto Rico. He exercised the option in 1972 while a bona fide resident of Puerto Rico. He returned to the United States where he established residency and sold some of the shares he acquired by exercise of the option. *Held*, none of the gain from sale of the stock in 1974 is taxable as compensation because it represents income derived from Puerto Rican sources attributable to Fuentes' period of residency in Puerto Rico under sec. 933(2) and is, therefore, excludable from income.

*Robert O. Rogers* and *David S. Meisel*, for the petitioners.

*Michael W. Ford*, for the respondent.

GOFFE, *Judge:* The Commissioner determined deficiencies in the Federal income tax of petitioners as follows:

| Petitioners | Docket No. | Taxable Year | Deficiency | Addition to Tax Sec. 6651 (a) |
|---|---|---|---|---|
| Thomas R. and Phyllis R. Pledger | 10855-75 | 1970 | $ 13,042.03 | -0- |
| | | 1971 | 155,416.27 | -0- |
| | 6532-76 | 1973 | 265,024.80 | -0- |
| Fausto A. and Mary Jane Fuentes | 6533-76 | 1968 | 1,990.20 | $497.55 |
| | | 1969 | 2,039.73 | 509.93 |
| | | 1970 | 3,982.75 | 995.69 |
| | 6557-76 | 1972 | 236,084.83 | -0- |
| | | 1974 | 183,986.91 | -0- |

Respondent has conceded that Petitioners Fuentes are not liable for any deficiency in income tax or addition to tax for the taxable years 1968, 1969 and 1970 set forth above (docket No. 6533-76).

Upon a joint oral motion of the parties these cases were consolidated for trial, briefs and opinion.

The issues for our decision with respect to Petitioners Pledger are:

(1) whether the term "restriction" used in section 83(a)(1), Internal Revenue Code of 1954,[1] applies to restrictions imposed by law or only to contractual restrictions imposed by parties to a stock option agreement; and

(2) whether section 83 violates the 5th and 16th Amendments to the Constitution of the United States.

The issues for our decision with respect to Petitioners Fuentes are:

(1) whether the term "restriction" used in section 1.421-6(d)(2)(i), Income Tax Regs., applies to restrictions imposed by law or only to contractual restrictions imposed by parties in a stock option agreement;

(2) whether the provisions of section 1.421-6, Income Tax Regs., apply to a United States citizen residing in Puerto Rico at the time he exercises a stock option but then becomes a United States resident and sells stock received pursuant to the exercise of his option; and

(3) whether a restriction having a significant effect on the value of stock acquired by petitioner pursuant to a stock option agreement lapsed on March 6, 1974.

## FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and the exhibits attached thereto

[1] All section references are to the Internal Revenue Code of 1954, as amended.

are accordingly incorporated by this reference.

Thomas R. Pledger and his wife Phyllis R. Pledger resided at North Palm Beach, Florida, at the time they filed their petitions in the instant case. For the taxable years 1971 and 1973 they filed joint Federal income tax returns with the Internal Revenue Service Center at Chamblee, Georgia. Mrs. Pledger is a party to this proceeding simply because of her filing a joint return with her husband Thomas R. Pledger, who will be referred to herein as Pledger.

Pledger had been employed as an executive of Burnup & Sims, Inc. (Burnup & Sims) for several years prior to 1970. Burnup & Sims had its principal office in West Palm Beach, Florida, and was engaged in the business of designing, constructing and maintaining facilities for telephone, CATV and electric utilities. From 1968 to 1970 Mr. Riley V. Sims was chairman of the board, president and chief executive of Burnup & Sims. On July 15, 1970, Mr. Sims granted to Pledger an option to acquire 10,000 shares of Burnup & Sims owned by Mr. Sims for $20 per share.[2] With the passage of time the number of shares subject to the option increased to 30,000 shares due to stock splits and dividends. Correspondingly, the cost per share decreased to $6.67 per share.

On October 21, 1971, Pledger exercised his option and acquired 6,000 shares of Burnup & Sims for a purchase price of $40,000. On November 24, 1971, Pledger acquired the remaining 24,000 shares for a purchase price of $160,000. The mean between the bid and asked

[2]Mr. Sims owned a substantial number of outstanding shares of Burnup & Sims.

price of the stock, which was traded over the counter was $22.25 and $20.87 respectively on the dates Pledger acquired the stock. Pledger received the stock in connection with his performing services for Burnup & Sims.

The Burnup & Sims stock acquired by Pledger pursuant to the option agreement was not subject to a substantial risk of forfeiture and was not subject to a restriction which by its terms would never lapse. However, contemporaneous with his acquisition Pledger executed and delivered a letter to Mr. Sims which provided:

> The undersigned, Thomas R. Pledger, hereby represents and warrants to Riley V. Sims and to Burnup & Sims, Inc., a Delaware corporation ("Burnup & Sims"), that the 30,000 shares of Common Stock, par value $.10 per share, of Burnup & Sims (the "Shares") to be received by such undersigned on the date hereof from Mr. Sims are being acquired by the undersigned for the undersigned's own account for investment and not with a view to the sale, distribution or other disposition thereof and the undersigned represents and warrants that such shares shall not be sold, transferred or otherwise disposed of in violation of the Securities Act of 1933, as amended, or the General Rules and Regulations promulgated thereunder by the Securities and Exchange Commission (the "Act"). * * * The undersigned understands that all certificates representing the Shares shall be stamped or otherwise imprinted with a legend in substantially the following form:

> The shares represented by this certificate have not been registered under the Securities Act of 1933, as amended. The shares shall not be sold or transferred in the absence of an effective registration statement for the shares under the Securities Act of 1933, as amended, or an opinion of counsel to the Company prior to the proposed transaction that registration is not required under said Act.

In conjunction with this letter Pledger received stock certificates which contained the following legend:

> The shares represented by this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and may not be sold or transferred in the absence of an effective registration statement for the shares under the Securities Act of 1933, a so-called "no action letter" from the Securities and Exchange Commission stating that the Commission's staff will recommend that no action be taken by the Commission if the proposed transfer or disposition is effected as proposed, or an opinion of the corporation's counsel to the effect that registration is not required under said Act.

Pledger could have sold these shares pursuant to another private placement and the rights of a purchaser would not have been subject to a substantial risk of forfeiture. However, if Pledger had made such a sale the shares would have been subject to a discount of 35

percent from the fair market value of Burnup & Sims stock traded over the counter. The discount was due to the restrictions imposed by Pledger's investment letter representations.

On their joint Federal income tax return for the taxable year 1971 the Pledgers reported $195,363 as income described as "compensation factor of non-qualified stock option." They calculated the amount of compensation as follows:

| | |
|---|---|
| Value of Stock on Dates of Exercise (per appraisals) ..... | $395,363 |
| Amount Paid for Stock on Dates of Exercise ..... | 200,000 |
| Amount Determined to be Compensation (excess of value over amount paid) ..... | $195,363 |

The Commissioner, in his statutory notice of deficiency, determined that Pledger had taxable income in the year he exercised his option (1971) to the extent the fair market value of the stock exceeded the cost per share. Accordingly, the Commissioner increased Pledgers' taxable income in the amount of $239,137. He determined this amount as follows:

| Date | No. of Shares | Unit Price | Total Cost |
|---|---|---|---|
| 10/27/71 | 6,000 | $6.67 | $ 40,000 |
| 11/24/71 | 24,000 | 6.67 | 160,000 |
| TOTALS | 30,000 | | $200,000 |

| | | |
|---|---|---|
| Date of Exercise | 10/27/71 | 11/24/71 |
| Bid Price | $ 22 | $ 20⅝ |
| Asked Price | 22⅛ | 21⅛ |
| Mean | 22¼ | 20⅞ |
| Value ( 6,000 × $22¼) | 133,500 | |
| (24,000 × $20⅞) | | 501,000 |
| Cost, as above | 40,000 | 160,000 |
| Ordinary income, taxable upon exercise | $ 93,500 | $341,000 |
| Combined | (93,500) | 93,500 |
| Total for Year | | $434,500 |
| Amount Reported on 1971 Form 1040 | | 195,363 |
| Increase to Ordinary Income | | $239,137 |

Pursuant to this determination the Commissioner adjusted Pledger's basis in the stock so as to reflect the increase in compensation as determined. The taxable year 1973 with respect to Pledger is at issue solely for the purpose of computing the basis of the stock he sold during 1973 and the resulting gain. Pledgers' taxable year 1970 is not at issue due to agreement of the parties.

Fausto A. Fuentes and his wife Mary Jane Fuentes resided at Miami, Florida, at the time they filed their petitions in the instant case. For the taxable years 1972 and 1974 they filed joint Federal income tax returns with the Internal Revenue Service Center at Chamblee, Georgia. Mrs. Fuentes is a party to this proceeding simply because of her filing a joint return with her husband Fausto A. Fuentes who will be referred to herein as Fuentes.

Fuentes was an employee of Burnup & Sims for a number of years and during 1965 through 1968 he was

a member of the board of directors of Burnup & Sims. During 1960 Fuentes became vice president of Call, Burnup & Sims, Inc. of Puerto Rico which is a subsidiary of Burnup & Sims. Upon his becoming vice president, Fuentes moved to Puerto Rico. He retired at age 59 on February 20, 1972, and returned to the United States as a permanent resident on April 20, 1972.

On November 30, 1968, Mr. Sims granted to Fuentes a five-year option to purchase 3,500 shares of Burnup & Sims stock which Mr. Sims owned, at a price of $8.375 per share, or a total price of $29,312.50. The purpose of granting the option was to compensate Fuentes for services performed and to be performed in Puerto Rico. The option was not transferable and had no readily ascertainable fair market value on the date Mr. Sims granted it. Burnup & Sims stock split during 1970 and 1971 and when Fuentes exercised his option on February 11, 1972, he purchased 15,750 shares for a price of $29,312.50. The mean between the bid and asked prices of Burnup & Sims stock traded over the counter was $32.50 on February 11, 1972.

In connection with the exercise of his option, Fuentes executed and delivered to Mr. Sims a letter regarding the ownership and disposition of the stock received by Fuentes. The letter contained the following declaration:

> The undersigned, Fausto A. Fuentes, hereby represents and warrants to Riley V. Sims and to Burnup & Sims Inc., a Delaware corporation ("Burnup & Sims"), that the 15,750 shares of Common Stock, par value $.10 per share, of Burnup & Sims (the "Shares") to be received

by such undersigned on the date hereof from Mr. Sims are being acquired by the undersigned for the undersigned's own account for investment and not with a view to the sale, distribution or other disposition thereof and the undersigned represents and warrants that such shares shall not be sold, transferred or otherwise disposed of in violation of the Securities Act of 1933, as amended, or the General Rules and Regulations promulgated thereunder by the Securities and Exchange Commission (the "Act"). The undersigned confirms his understanding that the Shares have not been registered under the Act and, except for sales made in reliance upon Rule 144 under the Act, must be held indefinitely unless the Shares are registered under such Act or an exemption from such registration is available. The undersigned further confirms his understanding that any sales made by him in reliance upon Rule 144 can only be made in limited amounts in accordance with the terms and conditions of such Rule.

The undersigned agrees that prior to any transfer or disposition of any Restricted Securities (as hereafter defined), the undersigned will give written notice to Burnup & Sims expressing such holder's intention to effect such transfer or disposition and describing briefly the proposed transfer or disposition. Such notice shall be accompanied by an opinion of counsel for the undersigned as to the status of the proposed transfer under the Act. Promptly upon receiving such notice Burnup & Sims

shall present copies thereof to its counsel and the following provisions shall apply:

1. If in the opinion of Burnup & Sims' counsel the proposed transfer or disposition of such Restricted Securities may be effected without registration of such Restricted Securities under the Act, Burnup & Sims shall promptly thereafter notify the undersigned, whereupon the undersigned shall be entitled to transfer such Restricted Securities, all in accordance with the terms of the notice delivered by the undersigned to Burnup & Sims.

Following his exercise of the option, Fuentes received stock certificates which contained a legend as follows:

The shares represented by this certificate have not been registered under the Securities Act of 1933. The shares have been acquired for investment and may not be sold or transferred in the absence of an effective registration statement for the shares under the Securities Act of 1933, a so-called "no action letter" from the Securities Exchange Commission stating that the Commission's staff will recommend that no action be taken by the Commission if the proposed transfer or disposition is effected as proposed, or an opinion of the corporation's counsel to the effect that registration is not required under said Act.

Fuentes could have sold the shares immediately following his exercise of the option by way of another private placement. Had he done so the shares would have been subject to a discount of 35 percent from the fair market value of Burnup & Sims stock traded over the counter.

On June 2, 1972, Burnup & Sims declared a 100 percent stock dividend and as a result Fuentes held 31,500 shares. Fuentes continued to hold the stock he acquired on February 11, 1972, but on March 6 and March 11, 1974, he sold 7,000 and 8,000 shares of Burnup & Sims stock, respectively, for a price of $20.08 per share. On the dates of the two sales the mean between the bid and asked prices of the stock traded over the counter were $20.75 and $22.375, respectively. On March 6, 1974, the following circumstances existed with respect to the stock acquired by Fuentes under the option:

(1) the shares had been owned and paid for by Fuentes for a period of two years of more;

(2) the shares did not exceed 1 percent of the outstanding common stock of Burnup & Sims;

(3) there was adequate information available to the public in regard to Burnup & Sims since it was in compliance with all reporting requirements of the Securities and Exchange Commission;

(4) the shares could have been sold in a broker's transaction; and

(5) if the shares were sold, a notice of such sale could have been filed concurrently with the Securities and Exchange Commission.

For the above reasons, Fuentes could have given the required notice to Burnup & Sims and obtained from its counsel an opinion that the shares could be sold without their registration with the Securities and Exchange Commission.

On their joint Federal income tax return for 1974 the Fuentes reported the sale of stock as follows:

| No. of Shares | Date Acquired | Date Sold | Gross Sales Price | Cost | Gain |
|---|---|---|---|---|---|
| 7,000 | 2/22/72 | 3/ 6/74 | $140,589.65 | $7,000 | $133,589.65 |
| 8,000 | 2/22/72 | 3/11/74 | 160,613.00 | 8,000 | 152,613.00 |
| Net long term gain | | | | | $286,202.65 |
| Less: (sec. 1202 deduction) | | | | | 143,101.33 |
| Income reported | | | | | $143,101.32 |

The Commissioner, in his statutory notice of deficiency, determined that Fuentes realized income in the amount of $482,562.50 in either the taxable year 1972 or 1974, arising from the stock option granted by Mr. Sims. Respondent now asserts that Fuentes realized this amount in the year 1974, rather than his alternative position relating to Fuentes' taxable year 1972.[3] In arriving at the amount of income ($482,562.50) the Commissioner determined that Fuentes received stock

[3]Respondent conceded at trial that no taxable event occurred during the taxable year 1972 with respect to Fuentes exercise of his stock option.

subject to restrictions which substantially affected its value at the time he exercised his option. He further determined these restrictions lapsed on March 6, 1974, and at that time Fuentes realized income to the extent that the fair market value of the acquired stock, as of February 11, 1972 (determined without regard to the restrictions), exceeded the amount Fuentes paid for the stock ($29,312.50). In addition, the Commissioner determined that "Riley V. Sims granted you this option to compensate you for services rendered and to be rendered to Burnup and Sims, Inc. within the United States and not apportionable to services rendered or to be rendered within and without the United States."

## OPINION

### Petitioners Pledger

The first issue for our decision is whether the term "restriction" as used in section 83(a) (1) applies to restrictions imposed by law or only to contractual restrictions imposed by parties to a stock option agreement.

During 1971 Pledger acquired 30,000 shares of Burnup & Sims stock pursuant to an option given to him in 1970 as compensation for services.[4] The stock he received, upon the exercise of his option, carried with

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[4]The option granted to Pledger the right to acquire 10,000 shares of Burnup & Sims stock at $20 per share. Through stock splits and dividends, the number of shares subject to the option increased to 30,000 shares and the cost per share decreased to $6.67 as of the date Pledger exercised the option.

it certain restrictions, as set forth in the findings of fact. These restrictions reduced the value of the stock by 35 percent of the amount he would have received from the sale of registered stock traded on the open market.[5]

On their joint Federal income tax return for the taxable year 1971 Pledger and his wife reported income from the exercise of the option in the amount of $195,363. They arrived at this amount by calculating the excess of the fair market value of the stock received over the amount paid for the stock.

Respondent takes the position that the amount of income realized from the exercise of the option is the excess of the fair market value of the stock over the amount paid for the stock without regard to the restrictions imposed on the stock which affected its value. His position is based upon the application of section 83 which provides in part:

> (a) General Rule. — If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —
>
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms

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[5]On the dates of Pledger's acquisition, October 21 and November 24, 1971, the mean between the bid and asked prices of Burnup & Sims registered stock was $22.25 and $20.875 respectively (per share).

will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

Pledger first contends that section 83 is unconstitutional because it imposes a tax on an amount (the excess of the fair market value over the amount paid) which is not realized income and, therefore, results in the application of an indirect tax which is not uniform. We do not agree. In *Sakol v. Commissioner*, 67 T.C. 986 (1977), affd. 574 F.2d 694 (2d Cir. 1978), cert. denied 439 U.S. _____ (1978), we held that the application of section 83 was entirely within the taxing power of Congress to tax income. We further held that the excess of the fair market value over the amount paid for the stock constituted income irrespective of receipt or nonreceipt. We stated at page 991:

> The formalistic concept of realization articulated in the cases upon which petitioner relies [and upon which Pledger relies, i.e., *Eisner v. Macomber*, 252 U.S. 189 (1920)] has been eroded by the passage of time and subsequent cases and clearly was never intended to define for all times the parameters of income subject to taxation. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Bruin*, 309 U.S. 461 (1940). Moreover, taxation despite nonreceipt is common and the actual reduction to possession is not a constitutional requirement. See, e.g. *Harrison v. Schaffner*, 312 U.S. 579 (1941); *Helvering v. Horst, supra; Lucas v. Earl*, 281 U.S. 111 (1930).

Pledger next argues that the application of section 83 violates the Fifth Amendment of the Constitution of the United States because it imposes a tax on a presumption of fact which he cannot controvert and is so arbitrary and unreasonable that it violates due process.[4] This argument is identical to that raised by taxpayer in *Sakol v. Commissioner, supra*, wherein we held that section 83 is constitutional. For the same reasons, as set forth in *Sakol*, we cannot agree with Pledger's argument.

Pledger finally contends that the term "restriction" in section 83 applies only to restrictions which are imposed by contractual agreement. By contrast, Pledger

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[4]Presumably, Pledger's position is that the conclusive measurement of income without regard to the restrictions imposed, which affect the value of the stock, is arbitrary and unreasonable.

argues that the restrictions on his stock were imposed by the application of law and, therefore, in applying section 83 the calculation of the fair market value of the stock he received during 1971 must be determined *with* regard to the restrictions (i.e., the 35 percent discount factor).

Respondent counters by arguing that the language of section 83 ("determined without regard to any restriction") is clear and plain and, therefore, section 83 encompasses restrictions imposed by law as well as those imposed by contractual agreement. He relies upon the proposition set forth in *Prudential Insurance Co. of America v. United States*, 319 F.2d 161 (Ct. Cl. 1963), wherein the Court stated:

> It is fundamental that an unambiguous statute should be given effect according to its plain and obvious meaning, Bate Refrigerating Co. v. Sulzberger, 157 U.S. 1, 36-37, 15 S.Ct. 508, 39 L.Ed. 601 (1895); Christner v. Poudre Valley Cooperative Ass'n, 235 F.2d 946, 950 (10th Cir., 1956). This principle is applicable to a revenue statute as it is to any other type of legislation. Crane v. Commissioner, 331 U.S. 1, 6, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947). [319 F.2d at 166.]

Accordingly, respondent contends that the word "any" does not limit the type of restrictions contemplated by section 83. In addition, respondent argues that judicial precedent and application of income tax regulations, which were in effect prior to the enactment of section 83, clearly demonstrate that restrictions imposed by law are included in the purview of section 83. We agree.

As respondent points out, prior to the enactment of section 83 the taxation of restricted stock received as compensation for services was governed by sections 1.61-2(d)(5) and 1.421-6(d)(2), Income Tax Regs. In this context, section 1.421-6(d)(2), Income Tax Regs., provided that if an employee received property pursuant to an option not covered by statute, which was subject to restrictions that substantially affected its value, the employee realized compensation when the restriction lapsed or the property was sold in an arm's-length transaction whichever occurred first. In *Hirsch v. Commissioner*, 51 T.C. 121 (1968), we held that Federal securities law was included in the term restrictions which affected the value of property received by an employee. In the following year, 1969, Congress enacted section 83 to end tax avoidance schemes. See *Sakol, supra* at 988-995. In an explanation of the purpose of section 83, H. Rept. No. 91-413 (1969), 1969-3 C.B. 255 states:

> For the above reasons your committee's bill provides that a person who receives a beneficial interest in property by reason of the performance of services is to be taxed with respect to the property at the time of receipt, either if his interest in the property is transferable or if it is not subject to a substantial risk of forfeiture. In this case the person is to be required to include in income the amount by which the fair market value of the property exceeds the amount (if any) he paid for the property. *For this purpose, the fair market value of the property is to be determined without regard to any restriction, except a*

> ***restriction which by its terms will never lapse.*** Restrictions which by their terms never lapse, for example, a requirement that an employee sell the stock back to the employer at book value or a formula price if he terminates his employment, are not, in your committee's opinion, tax motivated and should be distinguished from restrictions designed to achieve deferral for tax saving purposes. [Emphasis added.]

Making restrictions imposed by law an exception to the application of section 83(a)(1) would clearly thwart Congressional intent and result in transactions which Congress intended to eliminate, i.e., tax avoidance. Cf. *Bayley v. Commissioner*, 69 T.C. 234, 245 (1977). While some unfairness and inequity may result from the operation of section 83, Congress could rationally have concluded that such a result was justified by the ease and certainty of the section's operation. *Sakol, supra*, at 996. Therefore, we sustain respondent's determination.

**Petitioners Fuentes**

In 1960 Fuentes was employed by Burnup & Sims and moved to Puerto Rico where he became vice president of Call, Burnup & Sims, Inc. of Puerto Rico.[7] He was a resident of Puerto Rico until April 1972 at which time he returned to the United States and established residency. On November 30, 1968, Mr. Riley Sims, chairman of the board of Burnup & Sims, granted a

[7]This corporation was a subsidiary of Burnup & Sims.

5-year stock option to Fuentes whereby Fuentes had the right to purchase 3,500 shares of Burnup & Sims stock for $8.375 per share or a total purchase price of $29,312.50. The 5-year option was nontransferable and, therefore, had no readily ascertainable market value. On February 11, 1972, Fuentes exercised his option and purchased 15,750 shares of Burnup & Sims stock.[8] On this date the mean between the bid and asked price of the stock traded over the counter was $32.50.

Fuentes received the stock pursuant to a private placement which restricted its sale and thus substantially affected the value of the stock. He could have sold his stock immediately after he exercised his option but in doing so would have had to discount the value of the stock by 35 percent due to the restrictions.

On February 20, 1972, Fuentes retired at the age of 59 and on April 20, 1972, he returned to the United States and became a resident. Following his return Burnup & Sims declared a 100 percent stock dividend on June 2, 1972, after which Fuentes held 31,500 shares of stock.

On February 11, 1974, two years after Fuentes exercised his option, circumstances (as set forth in detail in our findings of fact) existed whereby he could have sold his stock without registration with the Securities and Exchange Commission. On March 6 and 11, 1974, Fuentes sold 7,000 and 8,000 shares respectively for

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[8]The increase in the number of shares received was due to stock splits which occurred in 1970 and 1971. The purchase price however remained the same; i.e., $29,312.50.

$20.08 per share. On those respective dates the mean between the bid and asking price of Burnup & Sims stock traded over the counter was $20.75 and $22.375.

Petitioner Fuentes contends that because the stock options were received and exercised while he was a bona fide resident of Puerto Rico he should not be taxed for compensation when he sold shares of the stock in 1974 or taxable at any other time, relying on section 933 of the Code. In the statutory notice the Commissioner determined that Mr. Sims granted the stock option to Fuentes in 1968 to compensate him for services rendered and to be rendered in the United States and not apportionable to services rendered or to be rendered within and without the United States. Of course, the statutory notice is presumptively correct but respondent never argued on brief that the determination of purpose for granting the option contained in the statutory notice was correct. Nevertheless, based upon the record, we hold that Petitioners Fuentes have sustained their burden of proving that this portion of the Commissioner's determination is erroneous. We, accordingly, found as a fact that Sims' purpose in granting the option to Fuentes in 1968 was to compensate him for services performed and to be performed in Puerto Rico. Fuentes was vice president of the corporate subsidiary since 1960 when he became a resident of Puerto Rico and he held that position until February 20, 1972, when he retired and then returned to the United States two months later. Fuentes' testimony amply demonstrates that the services he performed from 1960 to 1972 were on behalf of the subsidiary in Puerto Rico.

Section 933 of the Code provides as follows:

The following items shall not be included in gross income and shall be exempt from taxation under this subtitle:

(1) RESIDENT OF PUERTO RICO FOR ENTIRE TAXABLE YEAR. — In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received for services performed as an employee of the United States or any agency thereof); but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction under section 151, relating to personal exemptions) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

(2) TAXABLE YEAR OR CHANGE OF RESIDENCE FROM PUERTO RICO. — In the case of an individual citizen of the United States who has been a bona fide resident of Puerto Rico for a period of at least 2 years before the date on which he changes his residence from Puerto Rico, income derived from sources therein (except amounts received for services performed as an employee of the United States or any agency thereof) which is attributable to that part of such period of Puerto Rican residence before such date; but such individual shall not be allowed as a deduction from his gross income any deductions (other than the deduction for personal exemptions under section 151) properly allocable to or chargeable against amounts excluded from gross income under this paragraph.

Because Petitioners Fuentes returned to the United States to become residents on April 20, 1972, section 933(2) would be applicable to them. At the time of their return to the United States the Fuentes had been bona fide residents of Puerto Rico for 12 years. When Fuentes received the stock option in 1968, had he received compensation in the form of cash or property having an ascertainable fair market value, such compensation would have been excludable from U.S. income under section 933(1). Likewise, if on February 11, 1972, when Fuentes exercised the stock option granted to him in 1968, had he received compensation in the form of cash or property having an ascertainable fair market value, such compensation would have been excludable from U.S. income under section 933(2). Now, should the result be different because Fuentes instead received compensation in the form of a stock option in 1968 which he exercised in 1972 before terminating his residency in Puerto Rico? We think not.

The legislative history of section 933 as well as the legislative history of section 421 and their predecessor sections contains nothing to indicate that Congress ever considered the problem present in this case. The case law cited by the parties is likewise inconclusive. It is apparent, however, that the purpose for granting employee stock options after considerable litigation was not for a nontaxable purpose of granting a proprietary interest, but, instead, for the purpose of compensating the employee as the Supreme Court held in *Commissioner v. Lo Bue*, 351 U.S. 243 (1956). Since that time the Treasury Regulations have consistently taken such a position. In tracing through the historical development of legislation concerning employee stock options whether

qualified or not, restricted or not, having an ascertainable fair market value or not, there is a pervading common thread—compensation. In the instant case, the compensation was for services performed in Puerto Rico. We, therefore, conclude that Petitioner Fuentes should not be taxed on such compensation when he sold some of the stock in 1974.

Section 933(2) speaks of income *derived* from Puerto Rican sources which is *attributable* to the period of residency in Puerto Rico. Fuentes not only *received* the option while a bona fide resident of Puerto Rico he *exercised* the option and *purchased* the stock while a bona fide resident of Puerto Rico.

Respondent requested that we find as a fact that Fuentes did not report on his Puerto Rican income tax return for 1972 compensation resulting from the exercise of his stock option. Petitioners Fuentes object on the grounds of materiality. We agree with petitioners that such fact is not material. Respondent has not enlightened us with the Puerto Rican tax law applicable to 1972 nor does respondent point to any rule which holds that compensation arising from a stock option granted in Puerto Rico must be included in income in one jurisdiction if it was not included in income in the other jurisdiction.

Respondent argues that because Fuentes has failed to demonstrate that a specific exclusion from income applies to the stock he acquired pursuant to the option that section 1.421-6, Income Tax Regs., applies to him. We hold that Fuentes has sufficiently demonstrated the applicability of section 933(2) to exclude from income compensation received in the form of stock acquired pursuant to an employee stock option.

**Accordingly, we hold that Fuentes is not taxable on compensation in 1974 when he sold shares of Burnup & Sims stock.**

***Decisions will be entered under Rule 155 in docket Nos. 10855-75, 6532-76 and 6557-76.***

***Decision will be entered for petitioners in docket No. 6533-76.***

# Appendix B

Thomas R. PLEDGER and Phyllis R. Pledger,
*Petitioners-Appellants,*

v.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent-Appellee.*

No. 79-3279.

United States Court of Appeals,
Fifth Circuit.
Unit B
April 2, 1981.

A decision of the Tax Court, 71 T.C. 618, sustained a finding by the Internal Revenue Commissioner of a deficiency in income taxes. On appeal from the Tax Court, the Court of Appeals, Lewis R. Morgan, Circuit Judge, held that: (1) full value of corporate stock purchased pursuant to employee stock option and subject to certain temporary securities restrictions, less amount paid, could constitutionally be taxed as income, and (2) term "any restriction" in the relevant income tax statute included restrictions of investment letter as well as contractually imposed restrictions.

Affirmed.

1. Internal Revenue — 23

Progressive taxation scheme of income tax did not affect finding that income tax imposed upon stock received for performance of services was uniform. U.S.C.A. Const. Art. 1, §8; Amend. 16.

**2. Internal Revenue — 28**

Sixteenth Amendment did not limit or expand power of Congress to tax under constitutional provision authorizing Congress to lay and collect taxes, but, rather, simply provided for taxation of income without apportionment. U.S.C.A. Const. Art. 1, §8; Amend. 16.

**3. Stipulations — 14(10)**

Stipulation as to value of property if sold under certain circumstances does not necessarily reflect value, for income tax purposes, of property in hands of current owner. 26 U.S.C.A. §83(a); U.S.C.A. Const. Art. 1, §8; Amend. 16.

**4. Internal Revenue — 32**

Where taxpaying employee purchasing stock pursuant to stock option could receive only 65% of fair market value of stock if it was sold during period of restriction, stock being only temporarily subject to diminution in value, if exchanged, because of securities restrictions, full value of stock existed from moment of purchase and Congress could establish such value as taxable value without contravening Sixteenth Amendment, and could constitutionally tax full fair market value at time of purchase, less cost, without regard to temporary restriction, and there was no nonexistent value upon which he was taxed. 26 U.S.C.A. §83(a); Securities Act of 1933, §§1 et seq., 4(2), 15 U.S.C.A. §§77a et seq., 77d(2); U.S.C.A. Const. Art. 1, §8; Amends. 5, 16.

5. Constitutional Law — 286
Internal Revenue — 32

Statute under which taxpayer who could receive only 65% of market value of stock if it was sold during period of restriction was required to account for income tax purposes for full fair market value at time of purchase was not so arbitrary and capricious as to be unconstitutional as depriving taxpayer of property without due process. U.S.C.A. Const. Amends. 5, 16; 26 U.S.C.A. §83(a).

6. Internal Revenue — 157

Treasury regulations specifically including restrictions under federal and state securities laws as restrictions to be disregarded in applying income tax statute under which, if in connection with performance of services property is transferred to person other than person for whom such services are performed, the excess of fair market value of such property, determined without regard to restriction, over amount paid for property is to be included in income of person who performed the services were reasonable regulations, comporting with the statute. 26 U.S.C.A. §83(a).

7. Internal Revenue — 341

Income tax statute under which if, in connection with performance of services, property was transferred to any person other than person for whom services were performed, excess of fair market value of such property, determined without regard to restriction, over amount paid for said property must be included in

**gross income of person who performed services was enacted to prevent tax avoidance, and language concerning "any restriction" includes restrictions imposed by federal and state securities laws as well as contractually imposed restrictions. 26 U.S.C.A. §83(a).**

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Appeal from the Tax Court of the United States.

Before MORGAN, FAY and FRANK M. JOHNSON, Jr., Circuit Judges.

LEWIS R. MORGAN, Circuit Judge.

In this appeal from the Tax Court decision, 71 T.C. 618, sustaining the Commissioner's finding of deficiency, petitioner-appellant Pledger questions whether the full value of corporate stock purchased pursuant to an employee stock option and subject to certain securities restrictions can constitutionally be taxed as income under Section 83(a) of the Internal Revenue Code. The taxpayer also challenges the decision of the Tax Court that the term "any restriction" in section 83(a) includes the restrictions of an investment letter. Responding to these challenges, we affirm the decision of the Tax Court below.

The stipulated facts in this dispute reveal that Thomas R. Pledger[1] (Appellant) purchased 30,000 shares

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[1]This case is brought in the name of the appellant and his wife, Phyllis R. Pledger, because they filed jointly with the Internal Revenue Service in the tax years in question. Because Thomas R. Pledger is the primary party in this case, this opinion will hereinafter refer to him as the taxpayer.

of common stock of Burnup & Sims, Inc. pursuant to an option given to him in the previous year by Mr. Riley V. Sims, the president of the company, as compensation for services. Appellant purchased 6,000 shares in October of 1971 and purchased the remaining 24,000 shares in November. Upon acquiring the stock appellant executed and delivered to Mr. Sims an investment letter indicating that the stock was acquired for investment and not for sale.[2] The letter also stated that the stock certificates were to be stamped with a legend indicating that the shares were not registered under the Securities Act of 1933 and could not be sold absent an effective registration or a "no action" letter from the SEC.

Because of the restrictions imposed by the investment letter, the shares of stock were worth as stipulated only 65 percent of their fair market value if sold pursuant to another private placement during a two-year period after purchase. The taxpayer for the taxable year 1971 calculated the excess of the discounted value of the stock over the amount paid for the stock

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[2]This action was taken in order for the transaction to qualify as a private offering, exempted from registration requirements under the Securities Act of 1933 by §4(2) of that act. 15 U.S.C. §77d(2). Stock issued in these private offerings is commonly referred to as "lettered" stock, and is subject to certain restrictions regarding sale under the rules and regulations of the securities laws. This stock may be sold after a two year holding period without regard to restrictions if other conditions are met. Rule 144(d)(1), 17 C.F.R. §203.144 (1980).

and reported as income $195,363.[3] The Commissioner on audit increased the amount of compensation by $239,137 based on the difference between the amount the full fair market value exceeded the taxpayer's cost and the amount of taxes the taxpayer had paid.[4] From this the Commissioner determined a deficiency in the amount of $155,416 and accordingly adjusted the taxpayer's basis in the stock.

Appellant filed a petition for a redetermination of deficiency in the United States Tax Court. The Tax Court upheld the deficiency and the taxpayer appealed to this court.

I.

[1] The first issued raised by the appellant presents the recurring question of what is income. All parties agree that the option to purchase stock was compensation for services and that the purchase of the stock was a taxable event. Taxpayer asserts, however, that the government is utilizing Section 83(a) of the Internal

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[3]Appellant calculated the amount of compensation as follows:

| | |
|---|---|
| Value of Stock on Dates of Exercise (per appraisals) | $395,363 |
| Amount Paid for Stock on Dates of Exercise | 200,000 |
| Amount Determined to be Compensation (excess of value over amount paid) | $195,363 |

[4]The Commissioner calculated the amount of compensation as follows:

| | |
|---|---|
| Value of Stock on Dates of Exercise (per market value) | $634,500 |
| Amount Paid for Stock on Dates of Exercise | 200,00 |
| Amount Determined to be Compensation | $434,500 |
| Amount Reported on 1970 Form 1040 | $195,363 |
| Deficiency | $239,137 |

Revenue Code[3] to tax a nonexisting value, i.e., the excess of the fair market value of the stock over the discounted value. Section 83(a) provides that the value of compensation in the form of stock or other property for purposes of income taxation is to be determined by reference to the fair market value of the property "without regard to any restriction other than a restriction which by its terms will never lapse." 26 U.S.C. §83(a). To the degree this statute allows taxation of an amount

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[3]26 U.S.C. §83(a) (as added by §321(a) of the Tax Reform Act of 1969, P.L. 91—172, 83 Stat. 487). The statute provides in pertinent part as follows:

> Property transferred in connection with performance of services.
>
> (a) *General Rule.*—If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—
>
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

in excess of the value for which taxpayer could sell the stock during the time of restriction, taxpayer argues that the statute exceeds the powers of Congress to tax under the Sixteenth Amendment and Article 1, Section 8 of the Constitution.[6] Relying on the classic definition of income as presented in *Eisner v. Macomber*,[7] 252 U.S. 189, 207, 40 S.Ct. 189, 193, 64 L.Ed. 521 (1920), taxpayer argues that the excess value is not realized gain or "something of exchangeable value . . . derived from property." *Id.* With these contentions, we disagree.

[2] First, we note that the Sixteenth Amendment did not limit or expand the power of Congress to tax under Article 1, Section 8 of the Constitution. *See Brushaber v. Union Pac. R. R.*, 240 U.S. 1, 36 S.Ct. 236,

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[6]The Government argues that the taxpayer concedes that even if the tax is not appropriate under the Sixteenth Amendment, the tax could be upheld under the general taxing provisions of Article 1, Section 8 if the tax is uniform. The government is correct in arguing that the progressive taxation scheme of the income tax does not affect the finding that the tax imposed in this case is uniform. *See Knowlton v. Moore*, 178 U.S. 41, 20 S.Ct. 747, 44 L.Ed. 969 (1900); *Penn Mutual Indem. Co. v. Commissioner*, 32 T.C. 653 (1959), *aff'd* 277 F.2d 16 (3d Cir. 1960). However, because the real arguments in this case center on the issue of income, we base our decision on an analysis under the Sixteenth Amendment.

[7]Relying on two earlier cases the Court in *Eisner* stated:

> Income may be defined as the gain derived from capital, from labor, or from both combined . . . . [It is] a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *"derived"* that is, *received* or *drawn by* the recipient (the taxpayer *for his separate* use, benefit and disposal; *that* is income derived from property. (Emphasis in original).

60 L.Ed. 493 (1916). The Sixteenth Amendment simply provided for taxation of income without apportionment. In *Eisner v. Macomber, supra*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521, the Court attempted to define the term "income" used, but left undefined, in the Sixteenth Amendment. In that case, the court struck down a taxing statute on the ground that it attempted to tax stock dividends which were not income within the meaning of the Sixteenth Amendment. The case distinguished between income and capital without focusing particularly on the issue of compensation presented in this case. In defining income as "something of exchangeable value," the Court was stating what was income, not defining the amount of income received. Later developments in the tax law reveal that the definition was not intended as an all-encompassing implication of income. *See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S.Ct. 473, 476, 99 L.Ed. 483 (1955). *See generally* Note, "Apparent Abandonment of a Definitive Concept of Income," 45 *Harv.L.Rev.* 1072 (1923). The parties in this case agree that income was received; the only question is whether 65 percent of the fair market value or the full fair market value was received for purposes of taxation. The language of *Eisner* does not control this case. The taxing scheme does not contravene the language of *Eisner* defining income under the Sixteenth Amendment, and even if it did, the language of *Eisner* is not controlling where a different issue of income is presented.

In a challenge similar to the one in this case the Second Circuit held in *Sakol v. Commissioner*, 574 F.2d 694 (2d Cir.), *cert. denied* 439 U.S. 859, 99 S.Ct. 177, 58 L.Ed.2d 168 (1978), that Section 83(a) did not violate the

Sixteenth Amendment. In that case the taxpayer received as compensation what she claimed to be a lesser value than the fair market value of stock purchased pursuant to a stock option plan and subject to contractually imposed restrictions on the sale. The court considered that the language of *Eisner* requiring "gain" to be realized for "income" to exist had been modified by subsequent decisions upholding the accrual method of accounting, *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 51 S.Ct. 150, 75 L.Ed. 383 (1931), the doctrine of constructive receipt, *Corliss v. Bowers*, 281 U.S. 376, 50 S.Ct. 336, 74 L.Ed. 916 (1930), and the tax rules prohibiting assignment of income, *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940). *Id.* at 700. The court concluded that the power of Congress to create a realistic and workable tax scheme to prevent tax avoidance was sufficiently broad to permit the taxation scheme of Section 83(a).[8]

[3, 4] In this case when the taxpayer obtained the stock option, he received something of value. When he purchased the stock, the value of his compensation for purposes of taxation could be determined by reference to the fair market value of the stock on the day of purchase. Although taxpayer argues that the stock subject to the securities restrictions was worth only 65 percent of its fair market value, taxpayer ignores the fact that the stipulation regarding the 65 percent value

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[8]The dissent stresses that our reliance on *Sakol* is misplaced because of the distinction between governmentally imposed restrictions and contractually imposed restrictions. Although we do not solely rely on the rationale of that case, the distinction between the two cases is insufficient to require a different result. *See* note 14 and accompanying text *infra*.

pertained only to the discounted value if the stock were sold in another private placement sale.[9] A stipulation as to the value of property if sold under certain circumstances does not necessarily reflect the value of the property in the hands of the current owner.[10] Although the taxpayer could receive only 65 percent of the fair market value of the stock if sold during the period of the restriction, it does not necessarily follow that the only value the taxpayer received as compensation was 65 percent of the stock's fair market value. The full value of the stock existed from the moment of purchase; it was only temporarily subject to a diminution in value if exchanged because of the securities restrictions. Despite taxpayer's claim to the contrary, there was no nonexistent value upon which he was taxed.

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[9]The stipulation stated as follows:

11. On the respective dates that petitioner acquired the shares of Burnup & Sims, Inc. under the option, if he had offered said shares for sale in another private placement, such shares would have been subject to a discount of 35 percent from the fair market value of Burnup & Sims, Inc. stock traded over the counter because of the restrictions imposed by the petitioner's investment letter representations. Rec. at 71.

[10]At first glance the phrase "something of exchangeable value" in the definition of income under *Eisner* may seem to imply that the exchangeable value is the value of the property. Although this may be the standard measure for value of income, it does not apply in a case such as this where the property given as compensation is subject to temporary diminutions in value. As noted previously, the definition in *Eisner* did not establish how much income was received, but only whether income was received. In this case, although something of exchangeable value was received, the value of the income for purposes of taxation could not be determined by its immediate exchangeable value.

The problem in this case is primarily one of timing rather than value of what was received. If taxpayer were taxed on only 65 percent of the fair market value at the time of purchase, but held the stock until the restrictions lapsed, the remaining 35 percent of the fair market value which was also compensation to the taxpayer would be taxed upon sale at the more favorable capital gains rate. This 35 percent value is not an investment increase that the capital gains tax was designed to benefit. Assuming that the stock maintained its value, the 35 percent value was certain to accrue when the restriction lapsed. Appellant, however, argues that if the stock decreased in value, the taxpayer would initially be taxed at ordinary income rates for the full value but would only be allowed to deduct any decrease in value as a capital loss. This fact is arguably true[11] but is part of the risk any stockholder encounters when he purchases stock. A corporate employee purchasing stock pursuant to a stock option is not entitled to receive special tax benefits that a general purchaser of stock cannot receive, and indeed the corporate employee should not be heard to complain that he is *unfairly* taxed on the full fair market value of his compensation when the stock, with his knowledge and implicit consent, is subject to temporary restrictions. In order to achieve a workable and practical solution for taxation, Congress may constitutionally tax the full fair market value at the time of purchase without regard to the temporary restriction. *Sakol v. Commissioner*, *supra*, 574 F.2d at 700. Although this value is not the value taxpayer can

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[11]The Second Circuit in *Sakol* noted that a taxpayer in such a situation would be entitled at least to a capital loss. The Internal Revenue Service has not yet published its position as to whether ordinary treatment or capital treatment would be afforded.

receive upon immediate sale, Congress may establish this value as the taxable value without contravening the Sixteenth Amendment.

II.

[5] In addition to his argument based on the Sixteenth Amendment, appellant challenges the application of Section 83(a) under the due process clause of the Fifth Amendment. Relying primarily on *Heiner v. Donnan*, 285 U.S. 312, 52 S.Ct. 358, 76 L.Ed. 772 (1932), and *Schlesinger v. Wisconsin*, 270 U.S. 230, 46 S.Ct. 260, 70 L.Ed. 557 (1926), two cases which struck down statutes conclusively presuming certain gifts were made in contemplation of death, taxpayer argues that Section 83(a) operates as a conclusive presumption that "lettered" stock received as compensation has the same value as its registered counterpart. Because this value is a fiction, taxpayer argues, the statute deprives the taxpayer of property without due process of law.

The standard of review in the Fifth Circuit governing a due process challenge to a taxing statute is, as taxpayer concedes, whether the taxing statute is so arbitrary and capricious as to amount to a denial of due process. *Carr Staley, Inc. v. United States*, 496 F.2d 1366, 1375 (5th Cir.), *cert. denied*, 420 U.S. 963, 95 S.Ct. 1355, 43 L.Ed.2d 441 (1975). *See also Brushaber v. Union Pac. R.R.*, *supra*, 240 U.S. at 24—25, 36 S.Ct. at 244. The cases upon which taxpayer primarily relies, *Heiner v. Donnan*, *supra*, 285 F.2d 312, and *Schlesinger v. Wisconsin*, *supra*, 270 U.S. 230, 46 S.Ct. 260, 70 L.Ed. 557, applied this standard, holding that the creation of an irrebuttable presumption in the legislation in question was arbitrary

and capricious. The court in *Carr Staley, Inc. v. United States, supra*, 496 F.2d at 1374, considered these cases but held in that case that the earlier cases were not controlling and that a "reasonable basis in fact" would justify the statutory scheme. Thus, the irrebuttable presumption doctrine, to the degree it exists in taxing cases, clearly does not require a holding that any irrebuttable presumption is per se unconstitutional as an arbitrary and capricious statutory scheme. This view received further support from the Supreme Court's subsequent pronouncements concerning the irrebuttable presumption doctrine in *Weinberger v. Salfi*, 422 U.S. 749, 95 S.Ct. 2457, 45 L.Ed.2d 522 (1975), and *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 96 S.Ct. 2882, 49 L.Ed.2d 752 (1976), indicating that in "purely economic matters" the rational relationship test shall apply as the standard of review. At least one commentator[12] and one court [13] have recognized that these recent irrebuttable presumption cases have probably eroded the validity of *Heiner* and *Schlesinger*. Nevertheless, under either the Fifth Circuit or the Supreme Court standard, it is clear that the statutory scheme established by Congress for taxation is entitled to great deference by the courts and shall not be disturbed unless arbitrary and capricious and without a reasonable basis in fact. *See Sakol v. Commissioner, supra*, 574 F.2d at 698.

In applying the applicable standard to the facts of the case before the Court, we first note that the statutory scheme in question does not necessarily fall within the

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[12]See L. Tribe, *American Constitutional Law* §16-32, 1095 n. 25 (1978) (the early tax cases are "plainly not good law today.)

[13]*Sakol v. Commissioner, supra*, 574 F.2d at 698 n. 10.

parameters of the irrebuttable presumption doctrine. The statute does not establish an irrebuttable presumption on its face, and arguably does not establish an irrebuttable presumption at all. The statute does not dictate the actual value of the property held by the taxpayer, but simply provides as a matter of substantive law the manner in which it shall be taxed. Taxation of income is an area in which Congress is allowed great flexibility in order to eliminate tax avoidance. Nevertheless, assuming that the statute does establish an irrebuttable presumption, we hold that the statutory scheme is not arbitrary and capricious and is supported by a reasonable basis in fact.

As the Second Circuit noted in *Sakol v. Commissioner*, *supra*, 574 F.2d at 698, applying the rational relationship test of *Usery v. Turner Elkhorn Mining Co.*, *supra*, 428 U.S. 1, Congress could legitimately have enacted Section 83(a) to eliminate income tax avoidance through the use of restricted stock options. Although in a case such as the present one the sole motive for utilizing a stock option plan may not be tax avoidance, the issuance of "lettered" stock allows a corporation to compensate an employee with tax-favored income, except for Section 83(a). The corporation's choice of the use of a "lettered" stock plan may include both the motive of avoiding securities registration and the motive of providing tax-favored compensation. Thus, the rationale in *Sakol* regarding the purpose of Section 83(a) applies in this case as well. Congress may legitimately attempt to eliminate tax avoidance by taxing the full fair market value of stock purchased pursuant to the stock option plan without regard to any restrictions, whether contractually imposed or imposed under securities

regulations.[14] Taxpayers in both situations choose to participate in the stock option plan presumably with full awareness of the tax consequences under Section 83(a). *See Sakol v. Commissioner, supra*, 574 F.2d at 699. No legitimate reason exists for making a sharp line distinction between the types of restrictions.

The tax scheme imposed under Section 83(a) has a reasonable basis in fact in that the full value of the property purchased or given as compensation is indeed income subject only to temporary restrictions and diminution in value. As we explained in Section I of this opinion, the 65 percent stipulated value was only the monetary amount that taxpayer could receive if the property was immediately sold. The taxpayer, however, received more than the 65 percent stipulated value. The taxing scheme imposed by Congress more accurately reflects what taxpayer received as compensation than a scheme that taxes the taxpayer on merely a portion of the compensation. Thus the taxing scheme has a reasonable basis in fact. As the Second Circuit stated in *Sakol v. Commissioner, supra*, 574 F.2d at 701, "Congress may clothe the tax incidental to [nonqualified stock plans] with a ready-made, rather than custom-tailored, suit."

## III.

[6] In addition to his constitutional claims, taxpayer makes the final argument that the statutory term "any restriction" does not include restrictions on "lettered" stock imposed under the federal securities laws. Taxpayer

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[14] *See* note 8 *supra*.

argues that the statute applies only to contractually imposed restrictions such as those under consideration in *Sakol v. Commissioner, supra*, 574 F.2d 694.

First, the plain language of the statute seems to apply to security restrictions as well as contractually imposed restrictions. Secondly, we note that the Treasury Regulations specifically include restrictions under federal and state securities laws as restrictions to be disregarded under Section 83(a). Treas.Reg. §1.83(h), §1.83-5(c), Example (3). These regulations must be sustained unless plainly unreasonable or inconsistent with the language of the statute. *Fulman v. United States*, 434 U.S. 528, 533, 98 S.Ct. 841, 845, 55 L.Ed.2d 1 (1978). These regulations are both reasonable and comport with the language of the statute referring to "any restriction."

[7] Finally, the legislative history makes no distinction between contractually imposed and legally imposed restrictions. *See* H.R.Rep.No. 91-413, 91st Cong., 1st Session, *reprinted in* [1969] U.S.Code Cong. & Ad. News 1645; S.Rep.No. 91-552, 91st Cong., 1st Session, *reprinted in* [1969] U.S.Code Cong. & Ad. News 2027; Cong.Rep.No. 91-782, 91st Cong., 1st Session, *reprinted in* [1969] U.S.Code Cong. & Ad. News 2392. Although the committee reports refer primarily to contractually imposed restrictions, the statute was enacted to prevent tax avoidance. Whether this occurs through the use of contractually imposed restrictions or through utilization of securities restrictions in issuing "lettered" stock, the intent of Congress was to prohibit tax abuses. The language of Section 83(a) concerning "any restriction," therefore, includes restrictions imposed by the federal and state securities laws, such as the restrictions imposed in this case. The decision of the Tax Court is

AFFIRMED.

FAY, Circuit Judge, dissenting:

This Court today holds that a tax may be levied on purported gain from the exercise of certain stock options even though the Internal Revenue Service (Service) has stipulated that the actual value of those options at the time of the taxable event would not give rise to the realization of income asserted by the Service were the gain to be measured by the difference between the actual value and the cost of the options to petitioner-taxpayer. I respectfully dissent.

The facts of this case are very straight forward. In 1970, petitioner received, as compensation for employment, the option to purchase 30,000 shares of stock of his employer company. In 1971, petitioner exercised his options and purchased the shares, paying the agreed on option price of $200,000. The stock received by petitioner was "lettered." This was solely the result of the requirements of section 4(2) of the Securities Act of 1933, relating to the disposition of stock distributed in a "private placement." That section makes it unlawful to publicly trade stock issued in a private placement for a period of at least two years from the date of issuance.[1] Both parties agree that the exercise of the options was the taxable event giving rise to the realization of compensation income by petitioner. Most significantly,

[1]Stock subject to the restrictions of section 4(2) does not automatically become freely tradeable at the end of the two-year period. The Securities Act prescribes certain additional conditions that must be satisfied. Those conditions have no relevance to this appeal.

both parties agree that, at the time of the taxable event, the restrictions placed on the stock received by petitioner resulted in its actual value[2] being 35% less than the value of the same number of such shares that were not subject to the restrictions imposed by section 4(2) of the Securities Act. The Service nonetheless contends that, pursuant to section 83 of the Internal Revenue Code of 1954 (Code), petitioner may be taxed as though the value of the stock were what it would be were the legal restrictions not placed on it. Petitioner responds that the Service's position is premised on a wholly erroneous interpretation of Code §83 and that to tax such admittedly non-existent gain is unconstitutional.

Before considering the specific statute in question, a review of certain fundamental truisms of tax law might be helpful in properly focusing the issues. To begin with it is accepted that the power of Congress to levy taxes is not without limit. Prior to the adoption of the Sixteenth Amendment, a time which though so close is so very far away, the imposition of an income tax was unconstitutional. Subsequent to its adoption, Congress was authorized to institute a progressive tax, but only to the extent that the tax applied to income. Income is, as it was classically defined in *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920), the "gain derived from capital, from labor, or from both combined . . ." 252 U.S. at 207, 40 S.Ct. at 193. It is "something of exchangeable value *proceeding from*, the property . . . and *coming in*, being 'derived' that

[2]By actual value, I mean the amount which the parties stipulated as the fair market value of stocks so restricted.

is, *received* or *drawn* by the recipient (the taxpayer) *for his separate* use, benefit, and disposal—*that* is income derived from property. Nothing else answers the descriptions." 252 U.S. at 207, 40 S.Ct. at 103. I think it significant to remember that, although the definition of income has become more complex in response to the intricate tax laws and tax problems resulting therefrom, when the government seeks to tax something as income, it may do so only to the extent that "something of exchangeable value" was derived from labor or capital. By way of simple example, it is clear that if A, attorney, agrees to draft P, painter's, will in exchange for a painting worth $200, and at the end of the transaction P gives A a painting that would be worth $200 but for a hole in the canvas, that fact making it worth only $100, A may only be taxed to the extent of $100. A may only be taxed on the value of what he actually received, not on the value that the property would have had but for a condition affecting such value.

The general rule for the taxation of compensation income upon the receipt of property, rather than cash, is very simple. The taxpayer may be taxed on the fair market value of the property received less any amount which the taxpayer may have paid to receive the property. Taxable gain equals fair market value minus basis. Fair market value is that "price which would probably be agreed upon by a seller willing, but under no compulsion, to sell, and a buyer willing, but under no compulsion, to buy, where both have reasonable knowledge of the facts."[3]

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[3]Newberry, 39 BTA 1123 (1939).

The last and most indisputable truism is that people generally do not like to pay taxes. To that end, taxpayers have often gone to great lengths to devise schemes whereby they can avoid taxation on what properly should be taxable. Such schemes are known as "tax avoidance devices." Both Congress, by legislation, and the Service, by regulation, may recharacterize such schemes when their primary purpose is tax avoidance or deferral. Individual taxpayers are prevented thereby from agreeing to carry out transactions in a tax-free or tax-reducing form when the substance of the transaction should properly be structured as a fully taxable event.

Turning to the transaction in question, it appears without equivocation that, but for section 83 of the Code, the only gain on which petitioner would be taxable is the difference between the fair market value of the stock, as that value is decreased by the restrictions placed thereon, and the price paid for the stock.[4] The question then becomes whether section 83 was intended to affect the amount by which "lettered stock" would be taxed and, if so, whether that effect is constitutionally permissible. I resolve both of those issues in the negative.

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[4]This is the standard measure of recognizable gain. Prior to adoption of section 83, the amount actually taxed would have been less than this standard measure. This was the result of the operation of regulations adopted in 1959, 1.421-6(d)(2), Income Tax Reg., providing that the tax on bargain purchases of stock subject to restrictions having a significant effect on value would be imposed only when the restrictions lapsed or the property was sold in an arm's-length transaction. The measure of income as ordinary gain income at that point was the lesser of the fair market value of the stock at the time of its acquisition, determined without regard to any restrictions, or the fair market value at the time the restrictions lapsed, over the cost of the stock.

Section 83 provides in pertinent part:

> If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—
>
> "(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> "(2) the amount (if any) paid for such property shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

It surely must be clear that to the extent Code §83 is applied to the present case in such a manner as to impose a tax on an amount greater than the difference between the stipulated value and the stipulated price of the stock, the statute is unconstitutional. The Service simply may not tax the excess of the value of unrestricted stock over the value of the restricted stock actually received. Whatever that excess is, it most certainly is not income. To say, as the Tax Court did in this case,

that "[w]hile some unfairness and inequity may result from the operation of section 83, Congress could rationally have concluded that such a result was justified by the ease and certainty of the section's operation," is to absolve both Congress and the Service of their duty to impose taxes within the parameters established by the Constitution.

The majority opinion suggests that this case requires this Court to determine the value of appellants' stock. That is incorrect. The value was stipulated by the taxpayer and Service as 65 percent of the market value of an equal number of freely tradeable shares. The issue in this case should be whether the government can tax an amount greater than the undisputed value of the property received. Rather than confront that question, the majority says, "A stipulation as to the value of property if sold under certain circumstances does not necessarily reflect the value of the property in the hands of the current owner. (footnote omitted) Although the taxpayer could receive only 65 percent of the fair market value of the stock if sold during the period of the restriction, it does not necessarily follow that the only value the taxpayer received as compensation was 65 percent of the stock's fair market value." *Slip opinion* at 5458-5459, at ___. While those statements may be true in a case in which valuation is contested, I am at a loss to understand their relevance to this case, because the parties agree on the value of the property received. Moreover, if there is some value other than that stipulated to by the parties, the majority gives no hint as to what it may be. The majority opinion goes on to say, "The full value of the stock existed from the moment of purchase; it was only temporarily subject to

a diminution in value if exchanged because of the securities restrictions." *Id.* Not only is that statement contrary to the parties' stipulation, it is logically unsupportable. In the first place, how can it be said that the full value existed at the time of purchase? It is undisputed that appellant could not have found anyone to give him that full value in exchange for the restricted shares. The logic of the majority opinion would lead to the conclusion, by way of simple example, that the holder of a ten-year bond whose present value is $100 and whose value at maturity is $200 could be taxed at the greater value because its present lower value was a temporary condition. Secondly, the majority makes the totally unsupported assumption that the present diminution in value is a temporary condition. When the restrictions on the stock lapse, its value will be the then existent market value. That value may be more or less than, and is unlikely to be the same as, the present market value. It is conceivable that the stock had reached an all-time high at the time the parties agreed to its value. In that situation, it would be grossly unfair to say that the value of the stock was only temporarily diminished.

To the extent that this Court and the Tax Court relied on *Sakol v. Commissioner*, 574 F.2d 694 (2d Cir. 1978), *aff'g* 67 T.C. 986 (1977), *cert. denied*, 439 U.S. 859 (1978), to justify the results reached here, I conclude that their reliance is misplaced. Moreover, it demonstrates a fundamental misunderstanding of the reasons for the adoption of Code §83. *Sakol involved a contractual agreement* between employer and employee that restricted the transferability of the stock purchased. *Sakol did not involve stock whose value was affected by legal restrictions imposed by the Securities Act.*

*Sakol* said that section 83 could be constitutionally applied so as to value the stock at an amount equal to that which it would have had without the *contractually created restrictions*. The rational for that holding was simply that the statute could be constitutionally applied to privately created contractual restrictions because such agreements had been used historically as a tax avoidance or tax deferral device to disguise income where it actually existed. In its holding in *Sakol*, the Second Circuit Court of Appeals specifically justified the application of section 83 to *contractually created restrictions on stock saying*, "Because nonqualified plans have been the vehicles of tax avoidance Congress may clothe the tax incidental to them with a ready-made, rather than a custom-tailored, suit." 574 F.2d at 701. The language of both courts' decisions makes it unequivocal, however, that the statute was only intended to apply to privately created contractual restrictions, not legally imposed restrictions. In framing the issue for the Second Circuit, Judge Oakes began the opinion by saying, "Is it constitutional . . . in taxing a corporate employee in connection with his purchase of his employer's stock, not to take into account any diminution in value of the stock that may be present by virtue of temporary *restrictions on transfer in the employer's underlying stock purchase plan?* (emphasis added) 574 F.2d at 695. In discussing the manner in which Congress intended section 83 to operate, the Court went on to say,

> It requires a taxpayer to include in gross income the excess of the stock's fair market value over its cost, as soon as the taxpayer's interest is no longer subject to a substantial risk of forfeiture. The actual value of the stock arguably

> may be less than the value of stock readily transferable on the open market *because of restrictions imposed by the stock purchase plan*. Nevertheless, *these restrictions*, other than permanent, nonlapsing restrictions, *may not be considered in determining fair market value.*

(emphasis added) *Id.* at 695-696. In the opinion affirmed by the Second Circuit, the Tax Court said, "[t]he section [83] provides that property transferred in connection with the performance of services is to be included in the income of the transferee in an amount which exceeds the employees' cost by the fair market value of the property transferred, *without regard to any contractual restriction on its disposition . . .*" (emphasis added) 67 T.C. at 989. The Tax Court later said, ". . . to minimize the potential for continued tax avoidance and to further discourage the use of restricted stock purchase plans as a means of obtaining an equity interest in one's employer, Congress decided to measure the income derived from such arrangements without regard to *transitory restrictions imposed by the parties* on the shares purchased." (emphasis added) 67 T.C. at 99. It is clear, therefore, that *Sakol* allows the application of section 83 to privately created restrictions on stock transfer *only* because those restrictions may operate as tax avoidance schemes. The same cannot be said of *governmentally imposed restrictions* on stock transfer.

It seems to me there is a critical distinction between holding that section 83 may constitutionally be applied to *private agreements* that restrict the transfer of stock, because such agreements are often used to disguise

the existence of income, and holding that section 83 may constitutionally be applied to *governmentally imposed restrictions* on the transfer of stock, when the effect is to tax income that *does not exist*.[5] Our Government does not have the authority to tax that amount. In this case the Service has stipulated that such value does not exist. The government's position distills to a combination of semantic gymnastics and bureaucratic convenience neither of which could possibly justify our violating such a fundamental principle.[6] It is unfortunate that this Court chooses to give an unconstitutional interpretation to a statute whose purposes and proper interpretation are constitutional.

Accordingly, I respectfully dissent.

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[5]The majority dismisses the distinction I draw between the contractually created restrictions in *Sakol* and the governmentally imposed restrictions here as "insufficient to require a different result." I am at somewhat of a loss to understand how such a significant difference can be disposed of with so little consideration. *See Opinion* notes 8 and 14 and accompanying text.

[6]The majority points out that, even with its ruling, all is not lost for the taxpayer. Should the value of the stock at the time it becomes freely tradeable equal its present value of 65 percent of market value, the taxpayer may recoup the $239,137 deficiency he has paid, as a capital loss. What the majority fails to note is that, assuming the appellant can take the maximum annual capital loss of $3,000 as provided for in Code section 1211, the entire amount could be recouped in slightly under eighty years. I cannot imagine that this offers great solace to the taxpayer.

# Appendix C

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT
OFFICE OF THE CLERK
April 29, 1981

MEMORANDUM TO COUNSEL OR PARTIES LISTED BELOW:

Re: 79-3279 THOMAS R. PLEDGER and PHYLLIS R. PLEDGER-vs-COMMISSIONER OF INTERNAL REVENUE

The following action has this day been taken in the above case;

☐ AN EXTENSION OF TIME has been granted to and including

for filing appellant's/petitioner's brief.
for filing appellee's/respondent's brief.
for filing reply brief.
for filing petition for rehearing.

☐ Motion to consolidate granted.
☐ Motion to supplement or correct the record granted.
☐ Motion for leave to file supplemental brief granted.
☐ Motion for leave to file brief *amicus curiae* is granted.
☐ Joint motion as to time for filing briefs granted.
☒ Order enclosed has been entered.
☐

GILBERT F. GANUCHEAU,
Clerk

BY: /s/ Joan Jackson
Deputy Clerk

cc: Messrs. Robert O. Rogers and
David S. Meisel
Mr. M. Carr Ferguson
Messrs. Gilbert E. Andrews
Gary R. Allen
Donald B. Susswein
Mr. Lester Stein

[FILED APR 29 1981]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT
UNIT B

No. 79-3279

THOMAS R. PLEDGER and PHYLLIS R. PLEDGER,
*Petitioners-Appellants,*

*versus*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent-Appellee.*

Appeal from the Decision of the United States Tax Court

ON PETITION FOR REHEARING AND PETITION FOR REHEARING EN BANC

(Opinion April 2, 1981, 5 Cir., 198____, ____ F.2d____).
(April 29, 1981)

Before MORGAN, FAY and FRANK M. JOHNSON, JR., Circuit Judges.

PER CURIAM:

(X) The Petition for Rehearing is DENIED and no member of this panel nor Judge of this Administrative Unit in regular active service having requested that the Court be polled on rehearing en banc (Rule 35,

Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16; Fifth Circuit Judicial Council Resolution of January 14, 1981), the suggestion for Rehearing En Banc is DENIED.

( ) The Petition for Rehearing is DENIED and the judges in regular active service of this Administrative Unit having been polled at the request of one of said judges and a majority of said judges not having voted in favor of it (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16; Fifth Circuit Judicial Council Resolution of January 14, 1981), the suggestion for Rehearing En Banc is also DENIED.

( ) A member of this Administrative Unit in active service having requested a poll on the reconsideration in this cause en banc, and a majority of the judges in active service of said unit not having voted in favor of it, rehearing en banc is DENIED.

ENTERED FOR THE COURT:

CLERK'S NOTE:
SEE RULE 41 FRAP
AND LOCAL RULE 17
FOR STAY OF THE MANDATE

# Appendix D

## FIFTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES OF AMERICA

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

## SIXTEENTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES OF AMERICA

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

## SECTION 83(a) OF THE INTERNAL REVENUE CODE OF 1954

"SEC. 83. PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) General Rule.—If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture."

## CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Petition for Certiorari, has this 24th day of July, been made on the counsel for the Commissioner of the Internal Revenue Service and the office of the Solicitor General of the United States, by depositing three copies thereof to each such party, first class postage prepaid to the United States mail, addressed as follows:

Gilbert E. Andrews, Chief
Appellate Section, Tax Division
United States Department of Justice
Washington, D.C. 20530

Solicitor General
Department of Justice
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Robert O. Rogers
Attorney for Petitioner

# Opposition

Office - Supreme Court, U.S.
FILED
OCT 5 1981
ALEXANDER L. STEVAS,
CLERK

No. 81-157

# In the Supreme Court of the United States

OCTOBER TERM, 1980

THOMAS R. PLEDGER AND PHYLLIS R. PLEDGER,
PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

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JOHN F. MURRAY
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## QUESTION PRESENTED

Whether Section 83(a) of the Internal Revenue Code of 1954, pursuant to which a person must include in gross income the excess of the fair market value of property received in connection with his employment over the amount paid, with the value of such property to be "determined without regard to any restriction other than a restriction which by its terms will never lapse," is constitutional under the Apportionment Clause of Article I, Section 9 of the Constitution, and the Due Process Clause of the Fifth Amendment.

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# In the Supreme Court of the United States

OCTOBER TERM, 1980

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No. 81-157

THOMAS R. PLEDGER AND PHYLLIS R. PLEDGER,
PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. 2-28) are reported at 71 T.C. 618. The opinion of the court of appeals (Pet. App. 30-56) is reported at 641 F. 2d 287.

### JURISDICTION

The judgment of the court of appeals was entered on April 2, 1981, and that court's order denying a timely filed petition for rehearing (Pet. App. 60-61) was entered on April 29, 1981. The petition for a writ of certiorari was filed on July 27, 1981. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### STATUTE INVOLVED

The provisions of Section 83(a) of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at Pet. App. 63-64.

## STATEMENT

In 1970, petitioner[1], an employee of Burnup & Sims, Inc., was granted an option to purchase a specified number of shares of that company's stock. Petitioner exercised the option in 1971, acquiring 30,000 shares of Burnup & Sims stock at a price of $6.67 per share. The stock was then trading on the over-the-counter market at approximately $21 per share. The stock petitioner acquired was subject to an "investment letter" executed by petitioner representing that he would not sell or dispose of the shares, which had not been registered under the Securities Act of 1933, in violation of the securities laws. Petitioner was free to sell the stock in a "private placement," but the price he could obtain by such a sale would be subject to a discount of up to 35% of the over-the-counter price (Pet. App. 6-9). Petitioner's "lettered stock" could also have been sold publicly at its quoted market price if it were thereafter registered or, following a two-year holding period, if the issuing company satisfied the public information requirements of Rule 144 of the Securities and Exchange Commission. 17 C.F.R. 230.144.

On his joint 1971 income tax return, petitioner included in gross income the difference between the option price and the appraised value of the stock taking into account the then existing trading restrictions. On audit, the Commissioner determined that, in accordance with Section 83(a) of the Internal Revenue Code of 1954 (26 U.S.C.), the proper amount to be included in petitioner's gross income was the difference between the option price and the stock's fair market value on the date of exercise determined without regard to the non-permanent restrictions (Pet. App. 9). In this proceeding brought by petitioner in the United States

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[1]Phyllis R. Pledger is a party to this proceeding solely because she joined with her husband in filing a joint income tax return for the year in question. Accordingly, references to "petitioner" are to Thomas R. Pledger.

Tax Court, petitioner contended that Section 83(a) is unconstitutional to the extent that it requires the inclusion in gross income of an amount greater than could be immediately realized on the sale or exchange of the stock in question. The Tax Court rejected that contention and sustained the deficiency (Pet. App. 16-22). The court of appeals affirmed, with one judge dissenting (Pet. App. 30-56).

## ARGUMENT

1. Petitioner argues (Pet. 3-8) that the decision below conflicts with this Court's constitutional rulings with regard to federal taxation in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), and *Heiner* v. *Donnan*, 285 U.S. 312 (1932). But petitioner's constitutional objections were properly rejected by the court below. Indeed, the decision in this case is in accord with *Sakol* v. *Commissioner*, 574 F. 2d 694 (2d Cir.), cert. denied, 439 U.S. 859 (1978). Moreover, in *Kolom* v. *Commissioner*, 644 F. 2d 1282, 1288 (9th Cir. 1981), petition for cert. pending, No. 81-99, the court upheld the adoption of the same valuation rule for the purpose of determining the amount subject to the minimum tax on the exercise of a "qualified" stock option.[2]

Prior to the adoption of Section 83 in 1969, temporary restrictions on the disposition of stock acquired on the exercise of "non-qualified" compensatory stock options were taken into account in determining the amount subject to tax, and, where a restriction would have a "significant" effect on value, taxation of the "bargain element" enjoyed

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[2]Where a stock option plan satisfies the "qualification" requirements of Section 422 of the Code, the "bargain element" enjoyed on exercise is not taxable under Section 83(a). It is, however, treated as an "item of tax preference" for minimum tax purposes under Section 57(a)(6) of the Code. The Regulations (upheld in *Kolom*, *supra*) specifically incorporate the valuation rules of Section 83(a). Treasury Regulations on Income Tax, Section 1.57-1(f)(3) (26 C.F.R.).

on the exercise of the option could be deferred until the stock was sold or the restriction had lapsed. See Treasury Regulations on Income Tax, Section 1.421-6(d)(2)(i) (26 C.F.R.). In 1969, Congress noted that such treatment was "significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements" (H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 86 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 120 (1969)). It therefore determined that this form of compensation would be more accurately and fairly taxed if employees receiving "restricted property" were taxed, as Section 83(a) now provides, as soon as their property rights were not subject to a substantial risk of forfeiture, with the amount subject to taxation determined without regard to any restrictions other than those which by their terms would never lapse.[3]

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[3]Although petitioner originally took the position that Section 83(a) should not be read as requiring that restrictions imposed under the securities laws be disregarded for this purpose, he has not renewed that contention here. Nevertheless, the amicus curiae brief filed in support of the petition by the Electronics Corporation of America (ECA) argues (at 14-19) that the pertinent Treasury Regulations on this point (Sections 1.83-3(h) and 1.83-5(c)) should be held invalid on this basis. But that issue is not before the Court because it is not raised in the petition.

At all events, the court below correctly ruled (Pet. App. 46) that nothing either in the terms of the statute or in its legislative history indicates that Congress intended to limit the effect of this rule to purely consensual restrictions on the transfer of option property. Congress has recently adopted provisions limiting the effect of Section 83(a), for future years, where the recipients of compensatory stock would be subject to potential "insider trading" liability on the resale of the stock under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b). See Section 83(c)(3) of the Code, as added by Section 252(a) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 260. It did not, however, modify the scope of Section 83(a) insofar as it applies to other types of restrictions under the securities laws.

The method of timing and measuring the receipt of this form of compensation adopted by Section 83(a) does not violate the Sixteenth Amendment. Article I, Section 8, constitutes the exclusive source of the taxing power, which this Court has noted "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pacific R.R.*, 240 U.S. 1, 12 (1916). The Sixteenth Amendment serves neither to expand nor to contract that power, but only to relieve Congress, in the case of income taxes, of the duty imposed by Article I, Section 9, to apportion direct taxes among the states. *Brushaber* v. *Union Pacific R.R.*, *supra*, 240 U.S. at 17-18; *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103, 112-113 (1916); *Penn Mutual Indemnity Co.* v. *Commissioner*, 32 T.C. 653 (1959), aff'd, 277 F. 2d 16 (3d Cir. 1960). Prior to the adoption of the Sixteenth Amendment, this Court had held, in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429, on rehearing, 158 U.S. 601 (1895), that a tax on income derived from real or personal property should be classified as a direct tax to the same extent as if it were imposed directly on the property itself. The Court recognized, however, that this analysis did not apply insofar as the income tax involved in that case was imposed on various other categories of income (including "gains or profits from business, privileges or employments" (158 U.S. at 635)).[4] Such taxes had always been considered "indirect." See *Springer* v. *United States*, 102 U.S. 586, 602 (1880); *Penn Mutual Indemnity Co.* v. *Commissioner*, *supra*; 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* para. 1.2.2 (1981).

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[4]While the Court held the statute there in question inoperative as a whole, it did so solely on the ground that Congress did not intend to subject other types of income to tax if rents, interest and dividends, etc., were not also subject to the tax (158 U.S. at 637).

Thus, as the Court recognized in *Eisner* v. *Macomber, supra*, 252 U.S. at 205-206, the realization of income concept was a material consideration only because the tax on stock dividends at issue in that case would also be considered a direct tax under *Pollock*. By contrast, Section 83(a) does not impose a direct tax based on ownership of property but an indirect tax on compensation in the form of property for services rendered. Cf. *Commissioner* v. *LoBue*, 351 U.S. 243, 247-248 (1956). Neither the Apportionment Clause of Article I, Section 9, nor the Sixteenth Amendment is pertinent to consideration of Congress' power to enact such a tax. Thus, contrary to petitioner's assertions (Pet. 4), the question presented here is wholly different from that presented in *Eisner* v. *Macomber, supra*. See *Sakol* v. *Commissioner, supra*, 574 F. 2d at 699-700.[5]

2. Petitioner further argues (Pet. 6-8) that Section 83(a) violates the Due Process Clause of the Fifth Amendment on the ground that the statute employs the type of "conclusive presumption" held invalid in *Heiner* v. *Donnan, supra*, and *Schlesinger* v. *Wisconsin*, 270 U.S. 230 (1926). But, as the court below noted, Section 83(a) does not establish an "irrebuttable presumption" of fact as to the "actual value of

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[5]Even if *Eisner* v. *Macomber* were in point, the realization concept employed by the Court in that case has been substantially eroded by such decisions as *Helvering* v. *Bruun*, 309 U.S. 461 (1940), and *Commissioner* v. *LoBue, supra*. Indeed, the amicus brief of ECA so recognizes (Br. 9). ECA would concede that the "actual fair market value of property received as compensation may be taxed without regard to whether it is transferable" (*ibid.*). ECA goes on, however, to suggest (Br. 11) that Section 83(a) is contrary to the income concept of *Burnet* v. *Logan*, 283 U.S. 404 (1931). But the decision there (permitting a taxpayer to recover her cost basis in certain stock before recognizing gain on its exchange for contingent contract rights) is not pertinent, even by analogy, to the tax treatment of transfers of temporarily restricted property as compensation for services. In *Logan*, the Court was not concerned with the scope of Congress' taxing power, but only with how the particular transaction should be taxed under the statutory scheme Congress had adopted.

the property held by the taxpayer, but simply provides as a matter of substantive law the manner in which it shall be taxed" (Pet. App. 44). Cf. *Ohio Bureau of Employment Services* v. *Hodory*, 431 U.S. 471, 490 n.18 (1977).[6] Although Section 83(a) may discourage the use of restricted stock as compensation, the statute does not arbitrarily tax "nonexistent" or "imaginary" value. Rather, the statute operates to deny what Congress believed were the unwarranted tax benefits and tax avoidance opportunities that accompanied compensatory transfers of restricted stock under prior law. As we have noted, such benefits were not available to other "non-qualified" forms of deferred compensation even though the employee's rights might be similarly restricted.

Moreover, in light of the special tax advantages allowed in the case of qualified stock options under Section 422 (see note 2, *supra*), it was entirely reasonable for Congress to deny the substantial tax deferral benefits previously available in the case of "restricted" option plans that failed to satisfy those requirements. Nor was Congress arbitrary and capricious, as ECA asserts (Br. 14-17), in adopting a broad "prophylactic rule" under which all non-permanent restrictions (including those arising under the securities laws) would be disregarded, and not simply those purely consensual restrictions adopted for tax avoidance purposes. Cf.

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[6]Nor does the statute conclusively presume, as petitioner contends (Pet. 6), that the fair market value of the property will not be diminished by the time those restrictions lapse and the property is sold. Because the basis of the property is increased by the amount taken into income, any such loss in value will ordinarily be recognized at that time. While ECA (Br. 18) and the dissenting judge (Pet. App. 56 n.6) assume that such a loss would be allowable only as a capital loss, the court below recognized (Pet. App. 41) that it remains an open question (and one not presented by the instant case) whether ordinary or capital loss treatment would then be appropriate. Cf. Treasury Regulations on Income Tax, Section 1.83-1(e) (26 C.F.R.), providing that a loss on a forfeiture of restricted property is allowable as an ordinary loss.

*Weinberger* v. *Salfi*, 422 U.S. 749, 777 (1975). Indeed, any distinction between consensual restrictions and restrictions under the securities laws, such as those involved here, may be of little significance because it may be within the control of the parties to determine, in the first instance, whether the option rights are to be satisfied with registered or with unregistered shares and, in the latter case, whether and when to satisfy the applicable requirements for the public sale of such stock.

At all events, as the court of appeals noted (Pet. App. 45), whether the restrictions are imposed by law or by contract, an employee who chooses to participate in a "restricted" stock option plan presumably does so with full awareness both of the tax consequences prescribed under Section 83(a), and also of the tax treatment allowed in the case of other forms of "qualified" and "non-qualified" deferred compensation arrangements. He is, thus, in no position to complain of a denial of due process when he elects to exercise option rights that will result in the inclusion in gross income of an amount greater than might be immediately realized on the sale or exchange of the property received. See *Sakol* v. *Commissioner*, *supra*, 574 F. 2d at 699.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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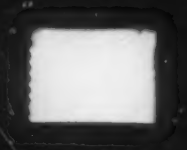
OCTOBER 1981

DOJ-1981-10

# Amicus Brief



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IN THE

# Supreme Court of the United States

**OCTOBER TERM, 1981**

**NO. 81-157**

THOMAS R. PLEDGER
AND
PHYLLIS R. PLEDGER,

*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit (Administrative Unit B)**

## BRIEF OF ELECTRONICS CORPORATION OF AMERICA AS *AMICUS CURIAE*

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*Respondent.*

---

**On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit (Administrative Unit B)**

---

## BRIEF OF ELECTRONICS CORPORATION OF AMERICA AS *AMICUS CURIAE*

## INTEREST OF *AMICUS CURIAE**

This brief is submitted on behalf of Electronics Corporation of America ("ECA"), as *Amicus Curiae*, urging the grant of the petition of the Petitioners, Thomas R. and Phyllis R. Pledger, for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit (Administrative Unit B).** That Court held that, with respect to stock received pursuant to the exercise of an option granted as compensation for personal services, the Congress of the United States could impose an income tax on the excess of the fair market value of the stock on the day of exercise, determined without regard to transfer restrictions imposed pursuant to the Federal securities laws, over the cost of the stock to the employee, without contravening the Constitution of the United States, even though the actual fair market value of the stock was stipulated by both parties to be only 65 percent of the fair market value so determined. The Court further held that the term "any restriction" in Section 83(a) of the Internal Revenue Code of 1954, as amended (the "Code" or "I.R.C."), includes restrictions imposed pursuant to the Federal securities laws as well as restrictions imposed by private agreement.

ECA has granted a number of stock options, the taxation of which is governed by Section 83, to various officers and key employees and is likely to grant such options in the future. ECA believes that these options, and the potential proprietary interest in ECA that they represent, are important factors in attracting good personnel and in motivating officers and key employees to perform their jobs in a superior fashion, thereby benefiting ECA and its share-

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* Letters of the Petitioners and Respondent giving their consent to file this brief have been filed with the Clerk of this Court.

** *Pledger* v. *Commissioner*, 641 F.2d 287 (5th Cir. 1981), *aff'g* 71 T.C. 618 (1979).

holders. The decision of the Court of Appeals for the Fifth Circuit in the *Pledger* case is a serious deterrent to such motivating factors because, under that decision, an employee is required to treat as income realized upon the exercise of an option an amount in excess of the option's actual value. The company further believes that the disregard of transfer restrictions in valuing stock for purposes of Section 83 is fundamentally unfair and unconstitutional.

## SUMMARY OF ARGUMENT

### I.

**Section 83(a), as construed under the Treasury Regulations, is unconstitutional.**

The relevant portions of the Treasury Regulations provide that limitations imposed under Federal or State "security laws" (sic) on the transfer of stock are included within the term "restriction" in Section 83(a). So construed, Section 83(a) would provide that an employee's gain upon the exercise of a stock option must be calculated by taking into account the "fair market value" of the stock determined without regard to restrictions imposed by the Federal government which may cause the actual fair market value of the stock to be significantly less. A tax may not be levied without apportionment on an amount which is neither actually nor constructively received. The excess of a hypothetical "fair market value," as determined under the Treasury Regulations, over actual fair market value does not represent either income or an amount actually or constructively received. Such excess may never be realized. The apportionment clauses and the Fifth Amendment of the Constitution do not permit the Federal government to tax such excess, at least where the fair

market value has been reduced by reason of restrictions imposed by the Federal government. In order to resolve this important question of Federal law, the Court should grant the petition for writ of certiorari.

## II.

**The Treasury Regulations, to the extent that they treat securities law restrictions as restrictions for purposes of Section 83(a), are invalid.**

The legislative history is unclear as to whether Congress intended that the word "restriction" in Section 83(a) include securities law restrictions. However, that history does indicate that Congress was primarily concerned with the tax avoidance schemes represented by restrictions imposed pursuant to private contractual agreement. Moreover, one of the rules of statutory construction is that statutes enacted by Congress are presumed to be constitutional. If Section 83(a) were interpreted in the manner provided in the Treasury Regulations, it would have to be struck down as unconstitutional. Accordingly, to the extent that the Treasury Regulations construe the word "restriction" in Section 83(a) as including securities law restrictions, the Treasury Regulations must be declared invalid as imposing an improper and unconstitutional construction on the statute. Furthermore, since Section 83(a) and the Treasury Regulations thereunder can operate in an arbitrary, capricious and unreasonable manner which could have been avoided by properly drafted Treasury Regulations, those Regulations must be declared invalid. In order to resolve this important question of Federal law, the petition for writ of certiorari should be granted.

## *ARGUMENT*

### I.

**Section 83(a), as construed under the Treasury Regulations, is unconstitutional.**

#### A. Taxation of gain generally.

Under the normal rules governing the taxation of gain for Federal income tax purposes, a taxpayer is deemed to realize gain in an amount equal to the excess, if any, of the "amount realized" by the taxpayer over the adjusted basis of the property disposed of. *See* I.R.C. § 1001(a). The amount realized is defined as "the sum of any money received plus the fair market value of the property (other than money) received." *See* I.R.C. § 1001(b). For Federal income tax purposes, the "fair market value" of property generally is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. *See* Treas. Reg. § 1.170A-1(c)(2); § 1.385-3(b)(1)(i); § 1.611-1(d)(2); *Newberry* v. *Commissioner*, 39 B.T.A. 1123 (1939); *cf.* Treas. Reg. § 20.2031-(1)(b) (same for estate tax); § 25.2512-1 (same for gift tax).

Applying this standard, the fair market value of the stock received by the Petitioners was stipulated to be 65 percent of the fair market value of stock identical in all respects but for the securities law restrictions. In general, the fair market value of stock subject to securities law restrictions, determined by taking into account those restrictions and the other relevant facts and circumstances (hereinafter referred to as the "actual fair market value") is significantly less than the fair market value of equivalent stock not subject to such restrictions. The actual fair market value generally is able to be readily determined by appraisal.

**B. Section 83(a).**

Section 83(a) of the Code represents an exception to the general rule discussed above. That section provides in pertinent part as follows:

> If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—
>
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (2) The amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable.

That is, under Section 83(a), the fair market value of the property received is not determined by taking into account all of the facts and circumstances but, on the contrary, by disregarding the effect of any "restriction" other than a permanent one.

**C. Securities law restrictions.**

The Treasury Regulations promulgated under Section 83(a) provide that "[l]imitations imposed by registration requirements of State or Federal security laws" (sic) and "similar" limitations are included within the term "restriction" in Section 83(a). Treas. Reg. § 1.83-3(h); *see* Treas. Reg. § 1.83-5(c) Ex. (3). Consequently, under the Treasury

Regulations, an employee who exercises a stock option and receives stock which has not been registered under the securities laws and consequently cannot be publicly traded is required to calculate his gain by determining the "fair market value" of the stock without regard to the limitations on the transfer of unregistered stock. In particular, an employee who exercises a stock option and receives stock which may be transferred only in accordance with the restrictions of Rule 144 of the Securities and Exchange Commission is required to determine his gain by disregarding such restrictions.

The result of applying Section 83(a), as construed by the Treasury Regulations, in such a situation is to tax the employee on the basis of an artificial, imaginary fair market value. As the *Pledger* case illustrates, such fair market value may bear little relationship to the actual fair market value of the stock. However, the restrictions themselves are not imaginary and, at the time the employee is deemed to realize income under Section 83(a), he would be able to sell the stock, if at all, only at a price taking the restrictions into account.

Furthermore, securities law restrictions do not originate in private agreement. In no way may they be viewed as self-imposed or voluntary. Rather, at least in the case of Federal securities law restrictions, they are imposed by the same government which seeks to disregard them for taxation purposes.

**D. The excess of the fair market value determined under Section 83(a) and the Treasury Regulations thereunder over the actual fair market value is neither income nor an amount received; therefore, under the apportionment clauses and the Fifth Amendment of the Constitution, it may not be taxed.**

The Petitioners received, pursuant to the exercise of employee stock options, stock whose transfer was subject to

securities law restrictions. The actual fair market value of this stock was stipulated to equal 65 percent of the fair market value of freely tradable shares. Nevertheless, under Section 83(a), the Internal Revenue Service computed gain on the basis of the fair market value of freely tradable shares. It is submitted that the excess of the fair market value determined under the Treasury Regulations over the actual fair market value, which excess the Petitioners might or might not eventually realize, is neither income nor an amount actually or constructively received.* Therefore, under the apportionment clauses (Article I, Section 2, Clause 3 and Article I, Section 9, Clause 4, contained in the Appendix hereto)** and the Fifth Amendment of the Constitution of the United States, such excess may not be taxed.

This Court has held that a pro rata dividend of common stock of a corporation to its common stock shareholders did not constitute income subject to tax under the Constitution of the United States. *Eisner* v. *Macomber*, 252 U.S. 189

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* Constructive receipt would include situations where the taxpayer has a fixed right to an ascertainable amount at a future date or where he has the power to direct the recipient or beneficiary of income but not where there is no reasonable assurance that the amount ever will come within the taxpayer's control so that it eventually might be realized.

** Unless imposed on "income" within the meaning of the Sixteenth Amendment of the Constitution, a "direct" tax may be levied only if apportioned among the States according to population. Where a tax is imposed in part on fictional amounts not actually or constructively received by the employee, the analysis which demonstrates that the tax is not a tax on income likewise demonstrates that the tax is not a tax on gross receipts, the use of property or the privilege of doing business (*i.e.*, is not an "indirect" tax), but rather is in effect a direct tax on property itself. Consequently, although the reference herein generally is to "income," the argument applies equally whether a direct or an indirect tax allegedly is involved. *See Sakol* v. *Commissioner*, 574 F.2d 694, 700 (2d Cir.), *cert. denied*, 439 U.S. 859 (1978).

(1920). A premise of that decision—that gain must be realized, in the sense of being "severed" from the underlying capital, in order to be income—has ceased to have validity. *See, e.g., Helvering* v. *Bruun*, 309 U.S. 461 (1940); *Prescott* v. *Commissioner*, 561 F.2d 1287 (8th Cir. 1977). In addition, the fair market value of stock received as compensation may be taxed without regard to whether or when it is sold or exchanged *(Commissioner* v. *LoBue*, 351 U.S. 243 (1956)), and the actual fair market value of property received as compensation may be taxed without regard to whether it is transferable. *See United States* v. *Drescher*, 179 F.2d 863 (2d Cir.), *cert. denied*, 340 U.S. 821 (1950).

ECA has no quarrel with these limitations on (or clarifications of) the *dicta* in *Eisner* v. *Macomber*. The Petitioners have acknowledged that they realized taxable income upon exercise of the stock options in question. Rather, the Petitioners' dispute concerns the *amount* of income which they in fact received and upon which they may be taxed. Until the enactment of Section 83 of the Code, it does not appear that any statute or court had rejected the principle that income can result only to the extent of a benefit (*i.e.*, an increase in wealth or in the enjoyment of goods or services) to the taxpayer or his designee. *See Penn Mutual Indemnity Co.* v. *Commissioner*, 32 T.C. 653, 680-81 (1959) (Train, J., dissenting), *aff'd*, 277 F.2d 16 (3d Cir. 1960). For example, in *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955), in taxing the punitive portion of treble antitrust damages, the Court reasoned: "Here we have instances of undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion." Similarly, in *Eder* v. *Commissioner*, 138 F.2d 27 (2d Cir. 1943), the Court held that the shareholder of a foreign personal holding company did not receive income in an amount equal to the undistributed net income of the company translated from Colombian pesos to United States

dollars at the rate of exchange of "free" pesos where Colombian law prohibited repatriation of the earnings; rather, the measure of income was the "economic satisfaction" which the shareholder could have received by investing or spending the earnings in Colombia or by selling the "blocked" pesos.

Furthermore, prior to Section 83, it seemed clear that income must be measured by the amount for which the property, at least theoretically, could be acquired or disposed of. For example, in *Drescher*, it was held that nontransferable annuity rights were taxable at their "present value," which was equivalent to the "cost . . . to acquire identical rights." 179 F.2d at 865-66. In other words, where a taxpayer receives an economic benefit, the amount of income represented thereby must be measured by the amount that a willing and able purchaser, having knowledge of the relevant facts and not under any compulsion to buy, would be willing to pay for the right to enjoy that benefit, assuming that the property could be sold and that such a purchaser in fact existed. Typically, as in *Eder* on remand, (3 T.C.M. 460 (1944)), the hypothetical price is determined by appraisal.

In the case of the Petitioners, that price was stipulated by the Petitioners and the government to equal 65 percent of the fair market value of shares not subject to securities law restrictions. That is to say, if the Petitioners were able to find someone willing to purchase the restricted shares in a private transaction, an arm's-length purchaser, it was estimated, would be willing to pay only 65 percent of the price of unrestricted shares. All of the rights received by the Petitioners in connection with the exercise of the stock option were taken into account in arriving at this value. *The Petitioners did not receive anything else.* Consequently, no other amount may be treated as income accruing to the Petitioners from this transaction.

In *Sakol* v. *Commissioner*, 574 F.2d 694 (2d Cir.), *cert. denied*, 439 U.S. 859 (1978), the Court of Appeals for the

Second Circuit upheld Section 83(a) against challenges on constitutional grounds where restrictions imposed solely by private agreement were involved. The Court reasoned:

> We conclude that a workable, practical system of taxing employees' restricted stock options can overlook, at least temporarily, a speculative decrease in value in ascertaining the amount of compensation received in the form of restricted stock where the employee has obtained both voting power and dividend rights.

574 F.2d at 700. (footnotes omitted). The rationale of the majority opinion for the Court of Appeals for the Fifth Circuit in the instant case was essentially the same. *See Pledger*, 641 F.2d at 291.

Both courts placed some weight on the need for a "workable" and "practical" system of taxation, and both relied upon *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931). However, that case dealt with the procedural need for a determinate, consistent annual accounting period, and held only that, where "the computation of income annually as the net result of all transactions within the year was a familiar practice . . . before the Sixteenth Amendment," such system did not violate the Sixteenth Amendment. 282 U.S. at 365. The question raised by Section 83(a), however, is more akin to that dealt with in *Burnet* v. *Logan*, 283 U.S. 404 (1931), where the Court held that a taxpayer who had sold stock under a contingent purchase price arrangement was not taxable on amounts received pursuant thereto until she had recovered her entire basis in the stock. The Court stated: "The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond." 283 U.S. at 412-13. *Cf. Sullenger* v. *Commissioner*, 11 T.C. 1076 (1948) (taxation of cost of goods sold would be uncon-

stitutional). So, in the case of employee stock options, the actual economic benefit to the taxpayer can be determined without speculation when the securities law restrictions lapse. While Congress may wish to tax the exercise of such options prior to the lapse of the restrictions, it cannot do so on the basis of a speculative value without allowing the taxpayer the right to prove a different value capable of fair determination. While administrative ease is a desirable aim, that end does not permit the government to tax phantom "income" where the actual income may be determined by appraisal and the taxpayer is ready and able to bear the burden of proving the amount thereof.

Second, both Courts of Appeal view Section 83(a) as creating only a "temporary" or "timing" problem in that the amount used as the "fair market value" of the stock in question might eventually be realized at such time as the transfer restrictions have lapsed. However, this approach is wholly contrary to the annual accounting period endorsed in *Sanford & Brooks Co.* More importantly, as Judge Fay's dissenting opinion in *Pledger* points out, when the restrictions on the stock lapse, its value "may be more or less than, and is unlikely to be the same as, the present market value." 641 F.2d at 286. That the value of the shares might decrease is no more "speculative" than that it might remain constant or increase. In the event that the value of the stock at the time that the restrictions lapse is lower than at the time that the stock was taken into income, the taxpayer would not be made whole but would be limited to claiming a capital loss. Furthermore, under Section 1211(b) of the Code, except to the extent that the taxpayer would have capital gains, he would be able to deduct a maximum of only $3,000 per year. *See Pledger*, 641 F.2d at 297 n.6 (Fay, J., dissenting); Crystal, *Taxes and Options*, N.Y. Times, Feb. 15, 1981, § 3 (Business), at 2, col. 5. While the *Pledger* majority dismisses this as "part of the risk any stockholder encounters when he pur-

chases stock" (641 F.2d at 291), the critical distinction is that a taxpayer subject to securities law restrictions would be unable to prevent or mitigate his loss by a timely sale of the shares at the market price of unrestricted shares.

Third, the fact that the taxpayer receives dividend and voting rights pursuant to the exercise of an employee stock option may be reason to treat the exercise of the option as a taxable event, but does not mean that he has received anything in addition to the amount determined to be the actual fair market value of the shares. As noted above, that value—65 percent of the fair market value of nonrestricted shares—encompassed *all* of the rights accruing to Petitioners as owners of the shares, including the right to receive dividends (which are separately taxable) and the right to vote the shares.

In short, the excess of the fair market value of shares, determined without regard to non-permanent restrictions, over the actual fair market value of those shares is not income in any sense of the word. Such excess represents an illusory amount which the Petitioners neither have received nor are entitled to receive.

Even assuming that a plausible argument can be made for treating such excess as income where the restrictions result solely from private agreement, this is not that case. Where restrictions are self-imposed by the parties, the situation, at least arguably, is analogous to those cases which tax a constructive receipt of income on the theory that the taxpayer has directed the income as he deemed fit. The practical necessity of preventing tax avoidance lends color to such an approach.

A similar rationale is not available where, as here, the restrictions are imposed by the Federal government. Under such circumstances, the impetus behind the restrictions is not tax avoidance but, rather, the effort to comply with the Federal securities laws.

The fact that not the Internal Revenue Service but a sister agency has imposed the transfer restrictions does not affect this result. Though separate agencies, they are arms of a single government. Under limitations inherent in the Due Process Clause of the Fifth Amendment of the Constitution of the United States, that government cannot simultaneously diminish the value of a person's property through its securities laws while subjecting that property to tax without regard to such diminution. The government cannot whipsaw a taxpayer to the government's enrichment.*

On the basis of the foregoing, it is submitted that the excess of the fair market value of shares received pursuant to the exercise of employee stock options, determined without regard to non-permanent restrictions pursuant to Section 83(a), over the actual fair market value of those shares is neither income nor an amount received; that such excess may not be taxed without apportionment among the several States according to population; and that, at least where such excess results from Federal securities law restrictions, taxation of such excess is so arbitrary, capricious and unreasonable as to constitute a taking of property without due process. Therefore, it is respectfully submitted that the petition for writ of certiorari be granted.

## II.

### The Treasury Regulations, to the extent that they treat securities law restrictions as restrictions for purposes of Section 83(a), are invalid.

#### A. Congressional intent regarding Section 83(a).

Section 83(a) of the Code provides that the effect of "any restriction," other than a permanent one, must be

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* This notion of fundamental fair dealing must be given effect regardless of whether the tax in question is viewed as a "direct" or an "indirect" tax under Article I, Section 9 of the Constitution.

disregarded in determining the fair market value of the property received. While the statute is worded very broadly, its intended scope is by no means clear. This is evidenced by the fact that Section 1.421-6(d)(2)(i) of the Treasury Regulations, which dealt with the taxation of restricted stock options prior to the enactment of Section 83(a), contained similarly broad language, *viz.*, "a restriction which has a significant effect on its value"; nevertheless, that provision was subjected to conflicting interpretations as to whether securities law restrictions were intended to be covered. *Compare Frank* v. *Commissioner*, 447 F.2d 552 (7th Cir. 1971) *with Hirsch* v. *Commissioner*, 51 T.C. 121 (1968), *acq.*, 1970-2 C.B. xx.

The legislative history involving Section 83 is ambiguous. On the one hand, the House Ways and Means Committee (but not the full House) apparently rejected a draft of Section 83 which expressly excluded securities law restrictions. *See* Technical Explanation of Treasury Tax Reform Proposals presented to the House of Representatives Ways and Means Committee, April 22, 1969, at 235-36, *reprinted in* Tax Management Primary Sources, Series I, Vol. 1, at 83.9-83.10. On the other hand, the relevant Committee Reports do not discuss securities law restrictions but instead refer to "restrictions designed to achieve deferral for tax savings purposes." *See* H.R. Rep. No. 413, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 200, 254-55; S.Rep. No. 552, 91st Cong., 1st Sess., *reprinted in* 1969-3 C.B. 423, 500-01.

However, Section 83(a) does direct that the amount determined thereunder be included in the taxpayer's "gross income." It does not appear that Congress intended to include a non-income amount in the computation of gross income, particularly where the resulting amount is subject to tax at graduated rates. Such inclusion indeed would be arbitrary, capricious and unreasonable. Since disregard of securities law restrictions in determining the amount

taxable under Section 83(a) would result in taxation of amounts in excess of gross income, the Court should interpret an ambiguous congressional intent to reach a constitutionally permissible result. Accordingly, such restrictions cannot and should not be disregarded.

**B. Since, if possible, a statute should be construed in accordance with the Constitution, the Treasury Regulations are invalid.**

In general, a statute enacted by Congress is presumed to be constitutional. *E.g., Buttfield* v. *Stranahan,* 192 U.S. 470, 492 (1904). If a statute is capable of two constructions, one of which renders the statute valid under the Constitution and one of which does not, the statute is to be construed so as to avoid the constitutional conflict. *E.g., Lucas* v. *Alexander,* 279 U.S. 573, 577 (1929).

As discussed above, Section 83(a) results in the imposition of "income" tax on fictional income whose eventual receipt is wholly speculative. Even if the restrictions are imposed by private agreement, arguably Section 83(a) results in an unconstitutional tax.

However, even if Section 83(a) were constitutional where applied to restrictions imposed by private agreement, it surely is not where government-imposed restrictions, such as those under the securities laws, are involved. Therefore, even if Section 83(a) could be determined to be a valid exercise of the congressional taxing power in the case of privately imposed restrictions, the statute must be construed in a manner which will avoid the clear constitutional conflict presented in the *Pledger* case. "The [Secretary of Treasury's] general authority to write regulations does not carry with it the same presumption of validity as the Congress' [sic] constitutional authority to write legislation." *Matheson* v. *Commissioner,* 74 T.C. 836 (1980), *acq.,* 1981-2 I.R.B. 5. This is especially the case where Congress's reference to "gross income" in Section 83(a) evidences an in-

tent to tax only such amounts and not amounts which may never be realized because of the securities laws. Therefore, the Treasury Regulations under Section 83(a), at least to the extent that they include securities law restrictions within the meaning of the term "restriction," must be held invalid.

### C. Since the Treasury Regulations are arbitrary, capricious and unreasonable, they are invalid.

As indicated at p. 12, *supra,* Section 83(a), as implemented by the Treasury Regulations, can work a fundamental and arbitrary unfairness. A taxpayer who exercises employee stock options is taxable at ordinary income rates on the excess of the fair market value of the stock received, determined without regard to non-permanent restrictions pursuant to Section 83(a), over the amount paid for the stock. Generally, however, the stock constitutes a capital asset in the hands of the taxpayer. Therefore, if the stock is subject to transfer restrictions and, as of the time such restrictions lapse, has suffered a decline in value, the taxpayer is entitled to claim not an ordinary loss but only a capital loss. This unreasonable treatment may be illustrated by the following hypothetical.

An employee who receives an option to purchase 5,000 shares at $50 each exercises it when the market price of freely tradable shares is $100 per share. However, under the Federal securities laws, the transfer of the shares is restricted for at least two years and the employee is required to sign an investment letter acknowledging such transfer restrictions. As a result of such transfer restrictions, the shares received by the employee have an actual fair market value of $65 each on the date of exercise. Under Section 83(a) and the Treasury Regulations thereunder, the employee would be required to include $250,000 in income. In the event that, when the transfer restrictions lapse (so that the taxpayer is able to transfer the shares at the market price without reduction for the transfer re-

strictions), that market price has dropped to $65 per share, the taxpayer would suffer a tax loss of $35 per share or $175,000. Since that loss would be a capital loss, however, it generally would only be able to be claimed in any given year to the extent of the taxpayer's capital gains, if any, for the year plus $3,000. *See* I.R.C. § 1211(b). Furthermore, assuming a long-term holding period, only 50 percent of the loss, or $87,500, would be able to be claimed as a deduction at all. *See* Treas. Reg. § 1.1211-1(b)(4)(iii).*

In the foregoing example then, the employee not only would be limited to a deduction for only 50 percent of his loss but, unless the taxpayer had significant capital gains, this amount would be deductible only over a period of more than 29 years. This is plainly an unreasonable and capricious outcome. Furthermore, since this result could have been avoided by the Treasury Department through properly drafted regulations, the Treasury Regulations are manifestly arbitrary and unfair. The Treasury Regulations could and should have provided for ordinary loss treatment on the disposition of restricted shares to the extent that the market price of the shares on the date the restrictions lapse is less than the market price, determined without regard to non-permanent restrictions, of such shares on the date that the option is exercised. Thus, in the above example, if the employee sells the shares for $65 per share on the date the securities law restrictions lapse, the taxpayer would have an ordinary loss of $35 per share to offset an equivalent amount taxed as ordinary income upon exercise of the option. Failure to so provide, especially in the case of securities law restrictions, compels the conclusion that the Treasury Regulations, as applied in this case, are constitutionally invalid.

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* The employee's plight could only be aggravated by the fact that, in general, he would have borrowed a substantial portion of the funds used to purchase the stock.

Accordingly, since the Treasury Regulations result in an unconstitutional construction of the statute, and since they are arbitrary, capricious and unreasonable, it is respectfully submitted that the petition for writ of certiorari be granted.

## CONCLUSION

**For all of the foregoing reasons, the petition for writ of certiorari should be granted.**

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# APPENDIX

## Article I, Section 2, Clause 3 of the Constitution of the United States of America

Representatives and direct taxes shall be apportioned among the several States which may be included within this Union according to their respective numbers, which shall be determined by adding to the whole number of free persons, including those bound to service for a term of years, and excluding Indians not taxed, three-fifths of all other persons.

## Article I, Section 9, Clause 4 of the Constitution of the United States of America

No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.